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February 15, 2013

Ms. Elizabeth M. Murphy
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: President's Working Group Report on Money Market Fund Reform; Rel. No. IC-29497; File No. 4-619; Comment submitted on the Proposed Recommendations Regarding Money Market Mutual Fund Reform (Docket No. FSOC-2012-0003).

Dear Ms. Murphy:

Enclosed is a copy of comments we submitted today on behalf of our client, Federated Investors, Inc., to the Financial Stability Oversight Council (the "Council") on the Council's recently issued *Proposed Recommendations Regarding Money Market Mutual Fund Reform*. We ask that our comments be made a part of the Commission's record.

Sincerely,

John D. Hawke, Jr.

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February 15, 2013

Financial Stability Oversight Council
c/o Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Attn: Amias Gerety

Re: Proposed Recommendations Regarding Money Market Mutual Fund Reform (Docket Number FSOC-2012-0003)

Dear Members of the Council:

We are writing on behalf of Federated Investors, Inc., and its subsidiaries ("Federated"),[1] to provide additional comments in response to the Financial Stability Oversight Council's (the "Council's") recently issued *Proposed Recommendations Regarding Money Market Mutual Fund Reform* ("Proposed Recommendations" or "Release").[2] The attachment to this letter also includes our response to specific questions raised in the Council's Release. This letter is in addition to our letter of December 17, 2012 regarding the Council's use of its Section 120 authority to make recommendations to the Securities and Exchange Commission ("SEC") regarding money market mutual

[1] Federated has thirty-nine years of experience in the business of managing MMFs and, during that period, has participated actively in the money market as it has developed over the years. The registration statement for Federated's Money Market Management fund first became effective on January 16, 1974, making it perhaps the longest continuously operating MMF to use the Amortized Cost Method. Federated also received one of the initial exemptive orders permitting use of the Amortized Cost Method in 1979.

[2] Proposed Recommendations Regarding Money Market Mutual Fund Reform, 77 Fed. Reg. 69455 (Nov. 19, 2012) ("Release"). All letters cited in this submission were filed in response to the Council's request for comment on the Release, and are available at the following website: http://www.regulations.gov/#!documentDetail;D=FSOC-2012-0003-0001.

funds ("MMFs"),[3] as well as three separate comment letters filed January 25, 2013 discussing each of the Council's three proposed recommendations to the SEC.[4]

To begin, we request that each member of the Council review the comment file, take a fresh look at the premises underlying the Council's Proposed Recommendations, and make decisions concerning any recommendation under Section 120 based upon the facts and sound economic data. The Proposed Recommendations are based upon two key premises, set forth in the Release: that "the 2007-2008 financial crisis demonstrated that MMFs are susceptible to runs that can have destabilizing implications for financial markets and the economy;"[5] and that characteristics and activities of MMFs "could create or increase the risk of significant liquidity, credit, or other problems spreading among bank holding companies and nonbank financial companies . . . ."[6] Thus, the central questions to be asked are:

(1) Would any of the proposals put forward in the Release have prevented the hoarding of cash and freeze-up in the short-term markets that took place during the depths of the financial crisis?

(2) If the proposals put forward in the Release had been in place in 2008, would they have prevented the flight to safety that occurred from virtually all asset classes?

(3) If MMFs had not existed in 2008, is there any reason to believe the seizing up of the commercial paper market and short-term credit markets more broadly would not have occurred?

(4) Would any of the proposals put forward in the Release prevent a "run" from MMFs or the short-term credit markets in a future financial crisis?

(5) If, as a result of regulatory restrictions, MMFs do not exist going forward, or if their assets under management are substantially reduced, where will those

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[3] Letter from John D. Hawke, Jr. to Financial Stability Oversight Council (Dec. 17, 2012).

[4] Letter from John D. Hawke, Jr. to Financial Stability Oversight Council (Jan. 25, 2013) (commenting on the floating NAV proposal); Letter from John D. Hawke, Jr. to Financial Stability Oversight Council (Jan. 25, 2013) (commenting on the MBR proposal); Letter from John D. Hawke, Jr. to Financial Stability Oversight Council (Jan. 25, 2013) (commenting on the capital proposal). *See also* Letter from Steven Keen on behalf of Federated Investors (Nov. 26, 2012) (discussing the proposal to price MMF shares at $100 per share); Letter from Michael Granito and Steven Keen (Jan. 30, 2013) (discussing the Council's lack of authority and legal basis for the Release).

[5] Release at 69455.

[6] *Id.* at 69456.

assets move, and will there be a reduction, or increase, in systemic risk in the financial markets?

(6) What steps are most critical for the Council to take to prepare for the possibility of a future financial crisis?

We believe the record demonstrates that the answer to the first four questions is a clear "no," and the answers to final two questions suggest that the Council is following the wrong path in seeking to choke off MMFs as a way to "stabilize" the economy in a future crisis. By the terms of the Release, the proposed "reforms" will not stabilize MMFs in a future financial crisis. According to the Release –

- A floating NAV "would not remove a shareholder's incentive to redeem whenever the shareholder believes that the NAV will decline significantly in the future . . . ."[7]

- The minimum balance at risk "likely would not be sufficient to stop a run on an MMF if investors anticipate very large losses" or stop a run on other funds if "investors expect that large losses would be incurred across MMFs."[8]

- The proposed capital requirements are "unlikely to be large enough to absorb all possible losses and may not be sufficient to prevent investors from redeeming when they expect possible losses in excess of the NAV buffer."[9]

If the goal is simply protecting investors in MMFs against the possibility that a MMF will "break the buck," why are MMF investors not lining up in support of the proposals? More fundamentally, why is the Council proposing "systemic risk" rules for MMFs that serve no purpose absent a crisis and will not work in a crisis? If the federal bank regulators wish to keep banks from relying too heavily on borrowing from MMFs, or to prevent banks from entering into too many commitments to support commercial paper bought by, among others, MMFs, then the banking regulators should impose rules on banks directly to limit those behaviors. It is neither necessary nor appropriate to regulate and change the structure of MMFs as a means to regulate banks.

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[7] *Id.* at 69467.

[8] *Id.* at 69471.

[9] *Id.* at 69475.

The former Chair of the Council and the former Chair of the SEC – the two members who set the pending Section 120 process in motion – have resigned their governmental positions and are no longer members of the Council. We submit that Congress intended the Council to be a true participatory body of individual voting members, and not simply a body to serve as a rubber stamp for the recommendations of any of its members or its chair. Particularly here, where the Council invokes its Section 120 authority for the first time, each voting member of the Council has an obligation to review the comments in the Council's docket and individually assess the premises upon which the proposals are based, evaluate whether the proposals will be effective in meeting their stated goals, and consider the potential adverse impact of the proposals on investors, financial stability, and the economy.

To date, Council staff and leadership have discounted or completely ignored the data, extensive analyses, and comments submitted by the fund industry and users of MMFs in opposition, apparently on the theory that comments of persons with an interest in the matter can be ignored by the agency. There are several problems with this approach. The Administrative Procedure Act ("APA") does not permit agencies to ignore the comments of interested parties.[10] Indeed, only those commenters with "standing" – a cognizable interest in the agency action – are permitted to challenge a rulemaking in court. Parties with an interest are in the best position to know and present the facts and issues so that a fully informed decision can be reached. The American judicial system is based upon courts gleaning the facts and issues through the presentation of opposing positions by the parties in interest to the matter in controversy. This concept is baked into the APA and cannot be cast aside by Council. The process should consider which comments are well supported and which are based on speculation. It is noteworthy that many of the commenters, such as state and local governments, pension plans, the American Bankers Association, trust companies, local chambers of commerce, and academics, do not represent the MMF industry, yet voice many of the same concerns regarding the Council's proposals.

We believe an objective review of the record will lead Council members to the conclusion that the Release grossly overstates the role of MMFs in the 2007-2008 financial crisis,[11] projects from this faulty narrative a role MMFs might play in any future

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[10] *Business Roundtable v. SEC*, 647 F. 3d 1144, 1149 (D.C. Cir. 2011) ("We agree with the petitioners and hold the Commission acted arbitrarily and capriciously for having failed once again . . . adequately to assess the economic effects of a new rule. [T]he Commission inconsistently and opportunistically framed the costs and benefits of the rule; failed adequately to quantify the certain costs or to explain why those costs could not be quantified; neglected to support its predictive judgments; contradicted itself; *and failed to respond to substantial problems raised by commenters*." (emphasis added)).

[11] Letter from Mutual Fund Directors Forum to Financial Stability Oversight Council (Feb. 8, 2013), ("[T]he problems in the underlying commercial paper and short-term credit markets suggest that investors were . . . unwilling, in a time of crisis, to lend money, even for short periods of time to high quality

Footnote continued on next page

financial crisis,[12] minimizes the impact of the SEC's 2010 amendments,[13] speculates (with no supporting data) about the effects of the three proposed alternatives in preventing or minimizing any "runs" in the future,[14] and wholly fails to assess and weigh the economic costs of the proposals versus their speculative and unfounded benefits.[15] Moreover, while focusing on MMFs, the Council has failed to assure that steps are in place to address a future financial crisis, which inevitably will occur, apart from anything that happens to MMFs.

Although the two members of the Council who were key proponents of the proposed restrictions on MMFs are no longer on the Council, the Chairman of the Federal Reserve Board remains a member and continues to advocate dramatic changes in the way MMFs are regulated, based on the premise that the events of 2007-2008 demonstrated the destabilizing effects of MMFs. We call upon the Council not only to reassess this view, but to assess those factors under the direct control of the Federal Reserve that led to the crisis, and to direct the Federal Reserve, not the SEC, to take action mandated by Congress to assure that the ad hoc approach taken by the government during a critical period in 2008 will not be repeated in a future crisis. Specifically, the Council should direct the Federal Reserve immediately to comply with the congressional mandate in Section 1101 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act") that it "establish, by regulation, in consultation with the Secretary of the Treasury, the policies and procedures governing emergency lending [in compliance with Section 1101] for the purpose of providing liquidity to the financial system."[16]

Footnote continued from previous page
borrowers, irrespective of whether that lending was intermediated by money market funds."). *See also* Letter from the Investment Company Institute to Financial Stability Oversight Council (January 24, 2013).

[12] Letter from Dreyfus Corporation to Financial Stability Oversight Council (Feb. 11, 2013); Letter from Steven Keen and Michael Granito to Financial Stability Oversight Council (Jan. 30, 2013).

[13] Letter from U.S. Chamber of Commerce to Financial Stability Oversight Council (Jan. 23, 2013); Letter from the Securities Industry and Financial Markets Association to Financial Stability Oversight Council (Jan. 14, 2013).

[14] Letter from Dreyfus Corporation to Financial Stability Oversight Council (Feb. 11, 2013); Letter from Steven Keen and Michael Granito (Jan. 30, 2013); Letter from John D. Hawke, Jr. to Financial Stability Oversight Council (Dec. 17, 2012).

[15] Letter from U.S. Chamber of Commerce to Financial Stability Oversight Council (Jan. 23, 2013); Letter from Jonathan Macey to Financial Stability Oversight Council (Nov. 27, 2012). *See also* Letter from American Benefits Council to Financial Stability Oversight Council (Feb. 1, 2013) (stating that the Council's Proposed Recommendations "could have unexpected adverse effects on plans that use these important investment vehicles. The special rules and considerations that apply to retirement plans must be considered by regulators before implementing any reforms as sweeping as those FSOC is considering.").

[16] Pub. L. No. 111-203 § 1101 (July 21, 2010) ("Dodd-Frank Act"); 12 U.S.C. § 343(B)(i).

Congress directed the Federal Reserve to undertake this rulemaking "[a]s soon as is practicable"[17] after the date of enactment of Dodd-Frank, specifically to avoid bailouts of individual institutions and to avoid the ad hoc and inconsistent approach taken in 2008, which the Financial Crisis Inquiry Commission (FCIC) concluded, "added to uncertainty and panic in the financial markets."[18] Yet, more than two and a half years after the enactment of this congressional directive, no rules under this section have even been proposed.

Root Causes of the Crisis. Federally regulated banks and large broker-dealers – virtually all of whom were primary dealers and counterparties of the Federal Reserve – were at the core of the crisis and turned the collapse of a housing bubble into a full-blown financial crisis. For years the Federal Reserve neglected to promulgate regulations to address known and growing abuses in the subprime mortgage market, and it failed to heed signs of a worsening crisis in late 2007 to early 2008 (as recently-released minutes of Federal Reserve Board meetings demonstrate).[19] Its officials were on site at Lehman Brothers from March of 2008 until its bankruptcy on September 15, 2008, and were well aware of its precarious financial condition throughout that period.[20] Following the Federal Reserve's funding of $29 billion of support for the emergency acquisition of Bear Stearns in March 2008, Chairman Bernanke made numerous public statements justifying why the government had come to the rescue of Bear Stearns to avoid a broader market collapse, including in congressional testimony on April 3, 2008[21] and again on July 10, 2008, when he told the public he "would do it again" to protect the financial system.[22]

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[17] *Id.*

[18] Financial Crisis Inquiry Commission, Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States at 343 (Jan. 2011) ("FCIC Report").

[19] Ylan Q. Mui, *Fed Slow to Abandon Optimism Even as a Few Sounded Alarm, 2007 Transcripts Show*, WASH. POST, Jan. 18, 2013, *available at* http://www.washingtonpost.com/business/economy/fed-slow-to-abandon-optimism-even-as-a-few-sounded-alarms-2007-transcripts-show/2013/01/18/410481b8-619a-11e2-9940-6fc488f3fecd_story.html; Board of Governors of the Federal Reserve System, *FOMC: Transcripts and Other Historical Materials, 2007* (last updated Feb. 8, 2013), http://www.federalreserve.gov/monetarypolicy/fomchistorical2007.htm.

[20] Report of Anton R. Valukas, Examiner, *In re* Lehman Brothers Holdings Inc., *et al.* at 8, 1469 (Bankr. S.D.N.Y.) No. 08-13555, http://jenner.com/lehman (citing the examiner's interview with SEC staff) ("Valukas Report").

[21] *See also Turmoil in U.S. Credit Markets: Examining the Recent Actions of the Federal Financial Regulators Before the S. Comm. on Banking, Housing, and Urban Affairs*, 110th Cong. 11-12 (Apr. 3, 2008) (statement of Chairman Ben Bernanke).

[22] *Systemic Risk and the Financial Markets: Hearing Before the H. Comm. on Financial Services*, 110th Cong. 35 (July 10, 2008) (statement of Chairman Ben Bernanke).

Yet, the Federal Reserve responded with a series of inconsistent and ad hoc measures during a critical period in September 2008 – actions that far more than any role played by MMFs shocked the markets, and, according to one FCIC member, "caused a halt to lending and a hoarding of cash – a virtually unprecedented period of market paralysis and panic."[23]

The fact that the Federal Reserve used its balance sheet ultimately to work its way out of the crisis it helped create should not give it license to write its own view of history and attempt to place MMFs at the heart of the crisis, and then advocate measures that could destroy them. MMFs are one of the few categories of liquidity providers remaining outside of the Federal Reserve's jurisdiction, which may explain, but does not justify, its efforts to control them.

The Council has a role to play in ensuring that the Federal Reserve, as well as the MMF industry and other market participants, is accountable and puts steps in place to address any future financial crisis. The Council has rapidly moved forward with a Section 120 proceeding against the SEC regarding MMFs (a subject not mentioned in the Dodd-Frank Act as requiring new regulation) that we and other commenters believe not only is unjustified, but unlawful as well.[24] At the same time, the Council has failed to even inquire as to why the Federal Reserve and Treasury have not complied with the clear mandate in Section 1101 of the Dodd-Frank Act to write rules for emergency lending that are transparent and known to the public and all market participants – rules that are far more relevant to the management of systemic risk than is MMF regulation. The Rules under Section 1101 are central to the purposes of the Dodd-Frank Act because they address the role of the government in responding to type of panic and freezing up of credit that occurs in a financial crisis.

The Role of the Federal Reserve as Liquidity Provider to the Financial System. Chairman Bernanke has justified proposals for major new limitations and requirements on MMFs by asserting, among other things, "The run in 2008 was stopped only by extraordinary interventions by the government, the Treasury, the Federal Reserve *using powers which, incidentally, are no longer available*."[25]

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[23] FCIC Report at 445.

[24] Letter from Investment Company Institute to Financial Stability Oversight Council (Jan. 25, 2013); Letter from U.S. Chamber of Commerce to Financial Stability Oversight Council (Jan. 23, 2013); Letter from John D. Hawke, Jr. to Financial Stability Oversight Council (Dec. 17, 2012).

[25] Open Session Meeting of the Financial Stability Oversight Council (Nov. 13, 2012) (statement of Ben Bernanke), http://www.yorkcast.com/treasury/ondemand/asx/2012/11/13/FSOC.asx (emphasis added).

As discussed below, it is true that federal law prohibits the Treasury from providing a MMF guarantee program in the future,[26] and the Dodd-Frank Act clearly prohibits bail outs of individual firms.[27] But, the Federal Reserve continues to have the power – and, indeed, the responsibility – to step in to provide broad-based liquidity to the markets in the event the commercial paper market freezes up in the future, due to a financial panic or other stress. It has used this power in the past, and will be called upon to fulfill this responsibility in a future crisis, regardless of what happens to MMFs. The Federal Reserve was created for the purpose of providing short-term credit to banks and liquidity to the secondary markets in commercial paper particularly during economic downturns. The Federal Reserve did not lend directly to MMFs during the financial crisis, and it should not be a lender to MMFs in the future. The purpose for which the Federal Reserve was created is to provide liquidity in the underlying short-term credit markets to keep the economy moving during periods of credit contraction, in order to counteract the effects of a pull-back by banks and other investors and lenders in these markets. These liquidity programs are not about MMFs, they are about the economy as a whole. Having a central bank that performs this function to keep markets liquid and the economy functioning when needed benefits all participants in the economy – workers, borrowers large and small, banks and other businesses, as well as taxpayers.

The Federal Reserve Bank of Dallas, in a comment submitted to the Council last month, noted that "the plunge in commercial paper market volume seen during the Great Recession is not a one-time event in the U.S. An even larger inflation-adjusted decline occurred in the Great Depression" and concludes from this fact that "there is a compelling need for the money market mutual fund industry to be reformed along the lines suggested by the recommendations proposed by the FSOC."[28] The logic of the comment, however, implodes when exposed to the simple fact that MMFs did not exist during the Great Depression, nor in the other major credit contractions that have gripped the nation prior to 2007. MMFs do not cause the flight to quality that is associated with a

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[26] Emergency Stabilization Act of 2008, Pub. L. No. 110-343 § 131(b) (Oct. 3, 2008); 12 U.S.C. § 5236(b).

[27] *See* S. REP. NO. 111-176 at 182 (2010) (citing then-Section 1151 (*Federal Reserve Act amendment on emergency lending authority*): "Emergency lending to an individual entity is no longer permitted. The Board of Governors now is authorized to lend to a participant in any program or facility with broad-based eligibility. Policies and procedures governing emergency lending must be established by regulation, in consultation with the Secretary of the Treasury. The Treasury Secretary must approve the establishment of any lending program. Lending programs must be designed to provide liquidity and not to aid a failing financial company. Collateral or other security for loans must be sufficient to protect taxpayers from losses. The Board of Governors must report to the Senate Committee on Banking, Housing and Urban Affairs and the House Committee on Financial Services on any 13(3) lending program within 7 days after it is initiated, and periodically thereafter.").

[28] Comment of the Federal Reserve Bank of Dallas to Financial Stability Oversight Council (Jan. 8, 2013).

credit contraction. "Reforming" (or eliminating) MMFs will not bring stability to the short-term credit markets any more than the non-existence of MMFs did prior to 1971.

Nor can the obligation to prop up short-term credit markets be shifted from the Federal Reserve System to MMFs and their shareholders. During the financial crisis, the Federal Reserve and SEC artfully used the commercial paper markets for six months as a federal policy tool to continue funding for Lehman Brothers by allowing that issuer to continue to issue paper without disclosure of its precarious financial condition, which was known both to the federal government and the issuer, but not the markets.[29] That effort ended badly when the true condition of Lehman was revealed to the markets in September 2008. The current effort by the Council to place on MMFs the yoke of funding short-term markets in a future crisis will similarly come up short. Shareholders in MMFs invest short-term balances for liquidity purposes, and will not remain as investors if their role is transformed into that of involuntary central bankers. Indeed, the suggestion that imposing a floating NAV on MMFs would have any impact on the supply of short-term credit during a future financial crisis is not rooted in reality. To suggest that imposing a minimum balance at risk with subordination would sufficiently penalize MMF investors so that they would be willing to remain invested in an MMF during a crisis, or that the existence of a small capital buffer would persuade MMF investors to keep funds in an MMF during a crisis when other investors are fleeing to safety, is equally counterfactual. None of the proposals in the Release will be effective in making MMF shareholders a source of emergency liquidity in a crisis, nor should they be.

The Federal Reserve was created after a long history of financial panics in the U.S. led to the creation of the National Monetary Commission (NMC) in 1907 to develop a set of recommendations to prevent or reduce the harms caused by financial panics, by providing a mechanism for providing extraordinary credit to short-term credit markets in

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[29] The report of the Lehman bankruptcy examiner was highly critical of the lack of disclosure of Lehman's precarious liquidity condition during the period June-September 2008. Valukas Report at 1451. The Report observes that on-site monitors from the Federal Reserve Bank of New York were aware of Lehman's failure to disclose its deteriorating position but declined to require that Lehman disclose this in public reports. Valukas Report at 1472. Notably, in July 2008, the SEC launched a very public investigation of short sellers and issued emergency orders to constrain short selling of the securities of primary dealers, telling the public that "rumors" of liquidity problems and "manipulation" were pressuring the stock prices of financial issuers and not "normal price discovery" based on fundamentals. Press Release, U.S. Sec. and Exch. Comm., Securities Regulators to Examine Industry Controls Against Manipulation of Securities Prices Through Intentionally Spreading False Information (July 13, 2008), http://www.sec.gov/news/press/2008/2008-140.htm; Emergency Order Pursuant to Section 12(k)(2) of the Securities Exchange Act of 1934 Taking Temporary Action to Respond to Market Developments, Securities Act Release No. 34-58166, 2008 WL 2743880 (July 15, 2008) (internal citations omitted).

times of stress.[30] The plan recommended by the NMC formed the basis for the Federal Reserve Act, which was enacted by Congress in 1913.[31]

The purpose underlying the Federal Reserve Act of 1913, as stated by Congress, was "[t]o provide for the establishment of the Federal reserve banks, to furnish an elastic currency, *to afford a means of rediscounting commercial paper,* to establish a more effective supervision of banking in the United States, and for other purposes."[32] Of the four stated Congressional purposes behind the Federal Reserve Act, one is specifically to provide liquidity to the commercial paper market, and that purpose was listed by Congress *ahead* of regulation of banks.

Since its creation, the Federal Reserve has provided liquidity to the short-term credit markets many times. For example, after Penn Central defaulted on its commercial paper and filed for bankruptcy in 1970, the commercial paper market become illiquid for other issuers. Issuers were no longer able to roll over their paper as it matured and holders of commercial paper were unable to sell it. The Federal Reserve provided an extraordinary credit facility to banks, secured by commercial paper purchased by the banks, as a way to encourage banks to purchase and hold commercial paper and provide liquidity to the commercial paper market. The Chairman of the Federal Reserve at the time announced that the Federal Reserve stood ready to lend directly or indirectly to firms that were unable to retire commercial paper, but this became unnecessary since its other steps resolved the crisis.[33] *Notably, MMFs were not even in existence at this time.*

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[30] Notable financial panics (and their economic aftermaths) have included the Panics of 1819 and 1837 (both of which were related to the Bank of the United States), the Panic of 1857 (triggered by an economic downturn, the sinking of the S.S. Central America with a loss of 550 passengers and crew and a cargo of 30,000 pounds of California gold, and the collapse of an Ohio insurance company and trust company), the Panic of 1873 (triggered by economic downturn, tumult in the silver market, the failure of Jay Cooke & Co. and the bankruptcy of numerous railroads and businesses), the "Hard Times" of 1893 (rapid overexpansion in agriculture and agricultural debt, decline in agricultural commodities prices, and general economic contraction), the Panic of 1901, and the Financial Panic of 1907. Of course, notable panics after the creation of the Federal Reserve occurred during the Great Depression of 1929-1939, the Penn Central bankruptcy in 1970, and the Financial Crisis of 2007-2009.

[31] Report of National Monetary Commission to Congress, Sen. Doc. No. 243, 62nd Cong., 2d Sess. (Jan. 9, 1912).

[32] Federal Reserve Act, Pub. L. No. 43 (1913); 12 U.S.C. § 221 *et seq.* (emphasis added). *See also* Board of Governors of the Federal Reserve System, *The Federal Reserve System, Purposes & Function* (2005), http://www.federalreserve.gov/pf/pdf/pf_complete.pdf.

[33] Dusan Stojanovic and Mark D. Vaughan**,** *The Commercial Paper Market: Who's Minding the Shop?* in Federal Reserve Bank of St. Louis, The Regional Economist (Apr. 1998); Charles W. Calomaris, *Is the Discount Window Really Necessary? A Penn Central Perspective*, NBER Working Paper No. 4573 (Dec. 1993).

The depth and severity of the 2007-2009 financial crisis required that the government pump massive liquidity into virtually every corner of the financial markets. As we have written in detail in earlier comments, the liquidity provided through the AMLF constituted less than 2% of the government's total emergency funds outstanding on a weighted average monthly basis.[34] These numbers alone suggest that the shrinkage of credit attributed to MMFs during the height of the financial crisis has been grossly inflated, by many multiples.

The critical point is that, in uncertain times there is always a market flight to quality, a contraction of private credit, and a tightening of liquidity in the short-term credit markets. This will occur regardless of whether MMFs exist and regardless of the structure of MMFs. The purpose of the Federal Reserve is to provide liquidity to the short-term credit markets in uncertain times. It served that role for 60 years prior to the creation of MMFs. Changing the fundamental structure of MMFs or doing away with them entirely will not lessen the need for the Federal Reserve to serve as the lender of last resort to provide liquidity to the short-term credit markets.

The Federal Reserve's Continuing Authority and Responsibility. Section 13(3) of the Federal Reserve Act, as amended by the Dodd-Frank Act, provides that, "in unusual and exigent circumstances, the Board of Governors of the Federal Reserve System [("Board")], by affirmative vote of not less than five members, may authorize any Federal reserve bank" to lend to "any participant in any program or facility with broad-based eligibility" provided that such loan is "secured to the satisfaction of the Federal reserve bank" and that the reserve bank has confirmed the participant is "unable to secure adequate credit accommodations from other banking institutions."[35] The Board must obtain the approval of the Secretary of the Treasury prior to implementing a program or facility under this section. A program or facility "structured to remove assets from the balance sheet of a single and specific company, or that is established for the purpose of assisting a single and specific company avoid bankruptcy" is not considered to have "broad-based eligibility" under Section 13(3).[36] The Dodd-Frank Act added the requirement of Treasury approval, as well as the prohibition on aid to an individual and/or insolvent institution.

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[34] Federated Investors, *Busting Through the Folklore About Money Market Funds: The Fact is They Cost Taxpayers Nothing*, American Banker, Jan. 19, 2012 at 8. *See* Office of the Inspector General, Board of Governors of the Federal Reserve System, *The Federal Reserve's Section 13(3) Lending Facilities to Support Overall Market Liquidity: Function, Status, and Risk Management* at 5 (Nov. 2010), http://www.federalreserve.gov/oig/files/FRS_Lending_Facilities_Report_final-11-23-10_web.pdf (AMLF utilization peaked at $152.1 billion.).

[35] 12 U.S.C. § 343(A).

[36] *Id.* at § 343(B)(iv).

As stated earlier, the Dodd-Frank Act also instructs the Board, "[a]s soon as practicable after the date of enactment," to "establish, by regulation, in consultation with the Secretary of the Treasury, the policies and procedures governing emergency lending under [amended Section 13(3)]."[37] The Act requires that such policies and procedures be designed to ensure that any emergency lending program or facility, (1) "is for the purpose of providing liquidity to the financial system, and not to aid a failing financial company," (2) "that the security for emergency loans is sufficient to protect taxpayers from losses" and (3) "that any such program is terminated in a timely and orderly fashion."[38] The Board, in its regulations, must also require that in administering such an emergency lending program or facility, a reserve bank must "assign, consistent with sound risk management practices and to ensure protection for the taxpayer, a lendable value to all collateral for a loan executed by a Federal reserve bank . . . in determining whether the loan is secured satisfactorily . . . ."[39]

Although the Dodd-Frank Act's revisions to the Board's section 13(3) powers would prevent it from aiding an individual distressed institution (for example, an AIG or Bear Stearns-type rescue), or an institution that, in the judgment of the administering reserve bank, could not post collateral sufficient to protect taxpayers from loss, it appears that amended section 13(3) would still permit the Board to authorize many of the types of liquidity facilities that were made available during the crisis.[40]

At an October 2011 hearing of the Joint Economic Committee, in response to statements made by Congressman Brady regarding the "precedents set in 2008" in aiding "clearly insolvent financial institutions," Chairman Bernanke summarized the effect of the Dodd-Frank Act on the Board's authority:

> [W]e would make sure that we would stand ready to provide as much liquidity against collateral as needed as lender-of-last-resort for our banking system.

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[37] *Id.* at § 343(B)(i).

[38] *Id.*

[39] *Id.*

[40] These included facilities for lending to primary dealers (as the Primary Dealer Credit Facility and the Term Securities Lending Facility did), U.S. depository institutions, bank holding companies, and MMFs (as the AMLF did and the Money Market Investor Funding Facility was intended to do, although the latter was never used), U.S. issuers of commercial paper (as the Commercial Paper Funding Facility did), and U.S. holders of asset-backed securities (as the Term Asset-Backed Securities Loan Facility did). *See* Federated Investors, *Busting Through the Folklore About Money Market Funds: The Fact is They Cost Taxpayers Nothing*, American Banker, Jan. 19, 2012 at 8.

> Congressman, you mentioned earlier the lender-of-last-resort policy regarding AIG and other individual firms, and I basically agree with you. I would just note that Dodd-Frank has made that illegal. We could not do that again. We are not allowed to do any lending to individual firms, or to insolvent firms. What we could do with the permission of the Secretary of the Treasury, is to provide a broad-based lending program to try to address a run on our financial system, which we do not anticipate, but we will certainly be prepared to respond if anything eventuates.[41]

Congress in the Dodd-Frank Act did not direct regulators to take action regarding MMFs, but it did direct the Federal Reserve "[a]s soon as is practicable" after the date of enactment, to establish, by regulation and in consultation with the Secretary of the Treasury, policies and procedures governing emergency lending for the purpose of providing liquidity to the financial system.[42] Two and one half years after Congress gave the Federal Reserve and the Secretary of the Treasury this mandate, no rules have been proposed. Instead, the Federal Reserve and the former Secretary of the Treasury have advocated the imposition of wide-ranging restrictions and requirements on MMFs that the Council, in its Release, recognizes would not staunch a run in a crisis. Instead of using its Section 120 authority arbitrarily to pressure the SEC to adopt these unsupported, ineffective and harmful proposals, the Council should invoke this authority to recommend that the Federal Reserve write the rules, mandated by Congress, that are directly relevant to mitigating or preventing future financial crises.

We urge all members of the Council to review the comments submitted in response to its Release and to give careful thought to the issues discussed in the attached paper as well as those raised by other commenters. We further urge the Council to withdraw its Release.

Sincerely,

John D. Hawke, Jr.

John D. Hawke, Jr.

Enclosure

[41] *The Economic Outlook: Hearing Before the Joint Economic Committee*, 112th Cong. 5, 12 (Oct. 4, 2011) (statement of Ben Bernanke).

[42] 12 U.S.C. § 343(B)(i).

cc: Ben S. Bernanke, Chairman of the Board of Governors of the Federal Reserve System
Richard Cordray, Director of the Consumer Financial Protection Bureau
Edward DeMarco, Acting Director of the Federal Housing Finance Agency
Gary Gensler, Chairman of the Commodity Futures Trading Commission
Martin Gruenberg, Acting Chairman of the Federal Deposit Insurance Corporation
Deborah Matz, Chairman of the National Credit Union Administration
Elisse B. Walter, Chairman of the U.S. Securities and Exchange Commission
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John P. Ducrest, Commissioner, Louisiana Office of Financial Institutions
John Huff, Director, Missouri Department of Insurance, Financial Institutions, and Professional Registration
David Massey, Deputy Securities Administrator, North Carolina Department of the Secretary of State, Securities Division
Michael McRaith, Director of the Federal Insurance Office
Eric Froman, Office of the General Counsel, Department of the Treasury
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Questions in FSOC Release Proposing Money Market Mutual Fund Reform
(FSOC - 2012 - 0003)

On November 19, 2012 the Financial Stability Oversight Council ("Council") issued proposed recommendations ("Release") regarding money market mutual funds ("MMFs"). The Release poses a series of questions regarding various reform proposals. The questions and our responses on behalf of Federated Investors, Inc. ("Federated") are set forth below.

I. Questions Relating to Alternative One: Floating Net Asset Value.

The Council's Alternative One would require all MMFs to maintain a floating net asset value ("NAV") rather than a stable NAV of $1.00 per share. Each MMF would also be required to re-price its shares to $100.00 per share (or initially sell them at that price), for the purpose of making the share price "more sensitive" to fluctuations in the value of the portfolio's underlying securities. According to the Council's Release, "a requirement that MMFs use floating NAVs could make investors less likely to redeem en masse when faced with the prospect of even modest losses by eliminating the 'cliff effect' associated with breaking the buck. Regular fluctuations in MMF NAVs likely would cause investors to become accustomed to, and more tolerant of, fluctuations in NAVs." The Release states that a floating NAV would also remove "uncertainty or confusion regarding who bears the risk of loss in an MMF." A floating NAV, according to the Release, "would reduce, though not eliminate, the first-mover advantage currently present in MMFs because all redemptions would be priced at a fund's per share mark-to-market price." The Release acknowledges that "[t]hough this first-mover advantage would be reduced, the incentive to redeem before others may remain . . . ." In particular, the Release states that a floating NAV "would not remove a shareholder's incentive to redeem whenever the shareholder believes that the NAV will decline significantly in the future." The Release also acknowledged certain tax, accounting, and operational impacts may occur with the adoption of a floating NAV for MMFs. In the case of tax impacts, the Release noted that "the Treasury Department and the IRS will consider administrative relief for both shareholders and fund sponsors," but did not provide information on when or how that would occur.

The Council requests comment on the floating NAV alternative as well as on all aspects of the discussion contained in its Release. The Council also requests any quantitative analysis or data from commenters relating to the floating NAV alternative. The following additional questions are posed in the Release:

- Would requiring that all MMFs operate with a floating NAV make them less susceptible to runs? *No.*
    - Would it reduce or increase the potential financial instability associated with MMFs? *Increase.*
    - Would it enhance their resiliency? *It would make them less resilient.*

The fact that a flight to safety from various asset classes, which began in 2007, ultimately hit prime MMFs in the week following Lehman's bankruptcy on September 15, 2008, does not support the underlying premise of these questions – that MMFs are "susceptible" to runs. Moreover, as discussed in detail in Arnold & Porter's January 25, 2013 comment on the floating NAV proposal, data from the performance of floating NAV MMFs and ultra-short bond funds during the financial crisis demonstrate that such funds experienced outflows at rates at or above those for stable value funds. Neither the Council, nor any other advocate for the floating NAV requirement, has produce a scintilla of data supporting the proposition that floating NAV funds are, or will in the future be, less susceptible to runs in periods of stress. Sheer speculation concerning an outcome, in the face of evidence to the contrary, should not be the basis for radical change to a financial product used by millions of individuals, businesses, and government entities.

- Would floating the NAV alter investor expectations and make them substantially more willing to bear losses from their MMF investments? Alternatively, would shareholders become accustomed only to relatively small fluctuations in value but redeem heavily in the face of more significant losses?

The premise of the question—that MMF shareholders are less "willing" to bear losses than shareholders in floating NAV funds—exposes the fundamental flaw in Alternative One. Any rational holder of a redeemable share will exercise the right of redemption to avoid an expected loss, regardless of whether the share is in a fund holding stocks, bonds or money market instruments. The type of fund a shareholder purchases, and the expected term of the investment, reflects the shareholder's risk tolerance. Generally, the longer the term of the investment the more risk a shareholder is willing to bear, while a shareholder making a short-term investment of cash is unwilling to risk a significant loss. In other words, it is the nature of the investment, not the investor, which reflects the willingness to bear risk.

Floating the NAV will not alter the nature of the cash investments currently made in MMFs. Therefore, there is no reason to expect it to alter "investor expectations" or, more accurately, investors' need to preserve the principal value of their cash investments. Floating the NAV will simply make MMFs incapable of meeting the needs of their shareholders.[1] *This is what makes it naïve to assume that shareholders will continue to invest the same amount of cash into MMFs if they are forced to float their NAVs.*

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[1] *See, e.g.,* Roundtable on Money Market Funds and Systemic Risk (May 10, 2011) (testimony of Kathryn L. Hewitt, Government Finance Officers Association) ("We use a mixture of investments, but this is one important piece of our investments, and that stable NAV is extremely important. If we don't have it, if we have a fluctuating one, for instance, my government won't be in it, okay, not with our regular operating cash. . . . [W]ith our daily operating cash that we have to pay our bills with, that, we need to have stability for."), http://www.sec.gov/spotlight/mmf-risk/mmf-risk-transcript-051011.htm; Roundtable on Money Market Funds and Systemic Risk (May 10, 2011) (testimony of Carol A. DeNale, CVS Caremark) ("I think what's missing here from a corporate treasurer perspective is, I am not running an investment house. I will not invest in a floating NAV product. I do not have the capacity.").

The question also mischaracterizes the risk characteristics of MMFs. MMFs plainly disclose a risk of loss to their shareholders. Moreover, shareholders fully appreciate this risk. This is true of both institutional[2] and retail[3] shareholders. As stated in Arnold & Porter's January 25, 2013 comment on the floating NAV proposal, the Council has offered no surveys or other data to support its claim that MMF investors are uncertain or confused about the investment nature of their MMF holdings. Use of amortized cost in compliance with Rule 2a-7 only assures that shareholders will not be affect by trivial and temporary fluctuations reflected in attempts to estimate the market value of the portfolio. The Council has not provided any justification for subjecting MMF shareholders to such meaningless fluctuations in estimated values.

Recent actions by MMFs to publish daily "shadow" NAVs make investors even more aware of fluctuations in MMFs' underlying NAVs. This new development gives regulators and the public an opportunity to monitor how useful daily shadow price information is to investors. Regulators should use this opportunity for further assessment before imposing regulations that would require MMFs to transact at a floating NAV.

- Would some MMF sponsors support their MMFs despite the elimination of rule 17a–9 (for instance, by contributing capital) under this option and thereby prevent their share prices from deviating materially on a day-to-day basis? *Some may.*
    - If so, would this mitigate the achievement of reform objectives? *No.*
    - Should sponsor support of MMFs be prohibited? *No.*

As discussed in Arnold & Porter's January 25, 2013 comment on the floating NAV proposal, the Council's proposed elimination of Rule 17a-9 conflicts with repeated SEC statements that sponsor support is in the interests of shareholders and does not have an adverse impact in terms of creating false expectations. In adopting the 2010 amendments, the SEC stated its belief that Rule 17a-9 would not "materially change shareholders' perceptions about money market funds or the likelihood of sponsor support during times of market turmoil" and praised the rule as being "in the best interest of the fund's shareholders." Money Market Fund Reform, *75 Fed. Reg. 10060 at 10087 (Mar. 4, 2010). The Council's recommendation to eliminate Rule 17a-9 contains no elaboration or supporting data to justify the rule's elimination.*

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[2] "As a public fund investor, I'm well aware that a money market mutual fund is not guaranteed. I'm aware that I'm investing in an investment product, and that is not a guaranteed return or a guaranteed $1 net asset value." Roundtable on Money Market Funds and Systemic Risk (May 10, 2011) (testimony of Kathryn L. Hewitt, Government Finance Officers Association), http://www.sec.gov/spotlight/mmf-risk/mmf-risk-transcript-051011.htm.

[3] Surveys of retail investors conducted by Fidelity Investments and submitted in a comment letter dated February 3, 2012 in response to the SEC's request for comment on the President's Working Group Report demonstrate that the vast majority of retail investors also understand that MMF investments are not guaranteed by the government.

- Each MMF would also be required to re-price its shares to $100.00 per share (or initially sell them at that price).
    - Would initially re-pricing MMF shares to $100.00 per share help sensitize investors to fluctuations in fund value and better change investor expectations? *No. Investors will leave MMFs.*
    - Should they be initially re-priced to a different value than $100.00 to best achieve this goal, for instance, $10.00? *No. MMFs should be permitted to continue to price shares at $1.00 if in strict compliance with Rule 2a-7.*

MMFs should not be required to re-price their shares to a set price. Contrary to the Release's representations, the requirement that MMFs price their shares at $100.00 per share (or any other price per share) is not "consistent with the requirements that apply to all other mutual funds." In fact, no current law or regulation requires an investment company under the Investment Company Act of 1940 to offer its shares at a particular price. Other investment companies that value their shares their shares at $10.00 do so by market custom, not as required by law or regulation. The Council's proposal would impose on MMFs an arbitrarily more stringent pricing standard than applied to other types of funds, a standard that would create fluctuations for their own sake, rather than seeking to prevent material dilution or other unfair results to shareholders, as required by the Investment Company Act of 1940. This issue is discussed in detail in Steven Keen's letter of November 26, 2012.

- Should existing MMFs be grandfathered for a limited phase-in period, as discussed above, or should they be grandfathered indefinitely?
    - What length of time should be the optimal phase-in period?
    - What length of time would be appropriate after which the SEC would prohibit any new share purchases in stable-NAV MMFs, and any new investments would have to be made in floating-NAV MMFs?

The Council's transition period makes no sense as proposed and reflects a misunderstanding of the needs of MMF users. As discussed in Arnold & Porter's January 25, 2013 comment on the floating NAV proposal, MMFs are used as cash management products by millions of investors. Given that 50% or more of the assets held in MMF portfolios may turn over in under a month, the structure of the transition period ensures that most users will have very little time to adjust to the floating NAV. As a result, MMF users will rapidly feel the effects of the burdens associated with the shift to a floating NAV, and the change itself is likely to bring about dislocations in short-term credit markets and the broader economy.

- Should the current basis reporting rules applicable to other mutual funds be extended to MMFs in their present form, or can those rules be simplified in a manner that better reflects the comparatively larger volume of transactions in MMF shares and the greater likelihood that gains or losses arising from those transactions will be relatively small on a per-share basis?

  - Are there changes to the basis-reporting rules, such as the use of rounding conventions, that would reduce compliance costs for MMFs while providing shareholders with the information they would need?

- Are there classes of MMF shareholders to which current law does not require basis reporting but which may be unable to obtain this information from an MMF fund in the absence of an explicit regulatory requirement?

As discussed extensively in the Investment Company Institute's ("ICI's") letter of January 24, 2013, floating NAV MMFs would be required to maintain and report cost basis information for redemptions throughout the year and also to transfer cost basis information if an account moves between brokers or between brokers and funds. The requirement would cause significant recordkeeping, operational, and compliance burdens. Administrative relief for de minimis amounts would lessen, although not remove, the compliance burden, as MMFs would still be required to track all transactions. As State Street points out in its letter of January 25, 2013, the cost to accommodate the floating NAV is simply not justified.

- If the Treasury Department and the IRS were to provide administrative relief for de minimis losses on wash sales of shares in MMFs, what should be the terms of that relief?

Administrative relief for de minimis losses on wash sales should be provided for all sales of shares of funds operating pursuant to Rule 2a-7 and should be codified in a rulemaking prior to the consideration of any regulations requiring MMFs to adopt a floating NAV. To assure the same tax treatment as MMF shareholders currently enjoy, the relief would need to exempt any redemption resulting in a loss of less than 0.5% from treatment as a wash sale. The Council in its Release cryptically refers to discussions with the Treasury Department and the IRS and suggests that those entities "will consider administrative relief for both shareholders and fund sponsors." However, the Council provides no assurances as to whether, when, and to what extent administrative relief will be provided. Of course, administrative relief on the federal level would do nothing to resolve the analogous state tax law issues.

- How significant are the accounting and operational considerations relating to floating-NAV MMFs?

As discussed at length in Arnold & Porter's January 25, 2013 comment letter on the floating NAV proposal and its December 15, 2011 letter filed in the SEC's PWG docket, requiring MMFs to adopt a floating NAV would require major changes to the accounting systems and automated interfaces of a variety of specialized systems that use MMFs to hold short-term liquidity in connection with the settlement of transactions. All of these systems would require significant and costly retooling. Thus, a floating NAV would make MMFs a substantially less attractive and more cumbersome product compared to other cash management alternatives.

This will cause a shift of assets away from MMFs and into less regulated, less transparent products or systemically important banks.

- To lessen possible issues arising from these considerations, what recommendations would commenters have for possible changes to accounting treatment for floating-NAV MMFs?

As discussed in Arnold & Porter's January 25, 2013 comment on the floating NAV proposal and the ICI's comment letter of January 24, 2013, investors would be required to report realized gains and losses on share transactions in floating NAV funds. Although this is true for transactions in other types of mutual funds, most investors do not transact in and out of other mutual funds as frequently as in MMFs. As a result, unless accounting standards setters afford cash equivalent status to floating NAV funds, regulators would need to provide formal guidance to the effect that some level of price fluctuation would not be considered material for GAAP purposes, and thus not subject to reporting. The guidance would also need to state that shares that provide daily liquidity and are not expected to experience material fluctuations in price may be classified as "cash equivalents." It is not clear, however, that the above efforts would maintain floating NAV MMFs as an attractive product for investors. Nor would this guidance resolve analogous issues of state tax law.

- What amount of operational costs would fund groups incur to implement a floating NAV for MMFs?

A floating NAV would be expensive to implement. Fund sponsors undertake a variety of administrative operations to support institutional investors' internal reporting and reporting to their own clients, including sending them daily information files on their holdings. If fund sponsors were required to implement a floating share price, rather than simply track a shadow price, fund sponsors would incur significant additional costs.

- To what extent are funds and their intermediaries currently prepared to operate floating-NAV MMFs on an ongoing basis due to the current requirement that MMFs be able to transact at a price other than the fund's stable price per share and as a result of the group's existing systems for their other mutual funds?

*Rule 2a-7 requires all MMFs and their transfer agents to have the ability to transact at share prices other than $1.00 (*i.e.*, to float their NAVs). The cost to MMFs themselves is not the main issue. The main issue is the cost to MMF users in the form of tax, accounting, and operational burdens with no tangible benefit. Further, intermediaries (of which there are thousands) are not equipped to transact at a floating NAV; rather than incur the expense associated with systems modifications, intermediaries will move to other products at significant disruption and cost.*

- Would investors and their accountants consider floating-NAV MMFs to be cash equivalents under relevant accounting guidance without clarification by accounting standard setters?

- If not, what are the implications for a shareholder that treats MMF shares as an investment for accounting purposes?

- If not, and if there were relief on the potential accounting considerations, would these funds be an attractive investment to investors?

As discussed above, if MMFs are required to adopt a floating NAV, MMFs likely will lose their cash equivalent status. Investors would be required to recognize gains or losses for financial accounting purposes, which would require new accounting systems and the overhaul of cash management processes to accommodate the possibility of gains or losses, whether an MMF's value actually fluctuates or not. The result would be substantial costs to investors that would leave MMFs a significantly less attractive product. Since the Council cannot guarantee that accounting standard setters will provide the relief it anticipates, many investors are likely to leave MMFs in favor of other cash management alternatives. Moreover, even if the issue of cash equivalency were solved, operational costs and burdens on users and intermediaries converting systems to a floating NAV would remain.

- Should any types of MMFs be exempt from a requirement that they operate with a floating NAV, such as retail MMFs, Treasury MMFs, or government MMFs? If so, why?
  - If there were an exemption for retail funds, how should the SEC define a retail MMF?

As stated above, because requiring MMFs to price shares based upon a floating NAV would not prevent runs in a crisis, and because investors currently have access to MMF daily shadow NAVs and are well aware that the stable NAV used by MMFs for transactions is not guaranteed, there is no policy reason to require any MMFs to adopt a floating NAV.

Before asking whether "retail" funds should be exempted from a floating NAV requirement and, if so, how they would be defined, the Council first should articulate the policy basis for exempting such "retail" funds. The Council's rationale for proposing a floating NAV in the first instance seems to be that if investors could observe small fluctuations in value, they would become more accustomed to, and more tolerant of, fluctuations in NAVs. However, it is simply not credible to suggest that investors are not aware of the small fluctuations in MMFs' underlying values, especially after the Reserve Fund's liquidation and more recently with the daily publication of shadow price information by MMFs. Institutional investors certainly have understood this for decades. Anyone who reads an MMF prospectus or marketing materials understands this. If the Council believes retail investors have less sophistication about this subject and/or are less able to monitor, then shouldn't the "protective" step of a floating NAV be provided for retail MMFs, and not institutional funds? If that is the Council's belief, their proposed solution is backwards.

If the policy reason for a floating NAV is that it will protect against "first-mover advantage," should not retail investors have that protection in "retail" funds, even more than institutional investors?

If the policy reason for a floating NAV is to protect retail investors from institutional investors, then perhaps regulators could attempt to divide MMFs into "retail" versus "institutional," but if MMFs are so divided, what is the policy reason to impose a floating NAV on institutional funds, if institutions can no longer take advantage of "retail" investors, because they are no longer in the same funds?

Segmenting funds into "institutional" and "retail" is challenging at best and will not address any of the policy goals of preventing a flight to safety in a financial crisis. If the cut between institutional and retail is based on size of the account, investors may seek to spread assets among various funds in order to stay below the size threshold. If "retail" is a proxy for "individual" investor, how would the Council address the issue of omnibus accounts and/or accounts managed by the same adviser? Many individual and institutional investors invest through their brokers, both on a cash sweep and directed basis. Both "institutional" and "retail" funds may have large omnibus accounts in which a registered broker-dealer is named as the record owner.

The Council is placing too much emphasis on the labels of "institutional" and "retail" used to report MMF statistics. Regardless of how they are labeled, many MMFs have a mixture of institutional and retail investors. If the policy reason for a floating NAV is an assumed difference in the propensity of retail shareholders to redeem as compared to institutional shareholders, then the Council needs to document this propensity and refine its analysis. The oft-repeated point that some funds labeled "institutional" experienced higher redemptions than some funds labeled "retail" during the financial crisis is not sufficient. Many so-called institutional funds experienced the same or even lower levels of redemptions as so-called retail funds during the period of high redemptions during the financial crisis, and many funds included both retail and institutional investors. This reflects the broad array of investors swept, inconsistently, under the label "institutional."

The fact is that that some institutional investors pose lower liquidity risks than some retail investors. Federated Investors performed an analysis[4] *for its MMFs during September 2008, which includes the aftermath of The Reserve Primary Fund's (the "Primary Fund")*

[4] Federated's transfer agent assigns "social codes" to accounts to identify the type of investor. Federated analyzed the purchase and redemption activity of each social code, treating social codes associated with individual investors as "retail," and social codes associated with other types of investors as "institutional." The transfer agent uses different social codes for omnibus accounts maintained primarily for individual investors (including broker omnibus accounts) and those maintained primarily for institutional investors. The analysis excluded social codes associated with accounts maintained by financial intermediaries who do not disclose sufficient information to classify the underlying investor. The excluded social codes represent approximately 20% of the assets held in Federated's MMFs, and illustrate how difficult it would be for an MMF board to obtain the data necessary to classify a MMF as an "Institutional" or "Retail" fund.

announcement that it had broken a dollar. This analysis was included in Federated's comment letter of September 8, 2009 filed with the SEC during the 2009-2010 rulemaking. It showed that the redemption activity of "retail investors" in Federated's MMFs was more volatile than the redemption activity of certain institutional investors. Specifically:

- *Retail investors redeemed the largest percentage of shares on any single day during the month. (7.9% on September 15, 2008).*

- *The largest percentage of shares redeemed by institutional investors (5.8%) occurred on September 17, the day after the Primary Fund "broke a dollar." However, retail investors redeemed almost the same percentage of their shares (5.6%) on this date.*

- *Redemptions by institutional omnibus accounts, which comprise over 80% of Federated's institutional MMF assets, were less volatile than the overall level of either retail or institutional redemptions. These omnibus accounts redeemed only 3.8% of their shares on September 17.*

- *Although the average daily redemptions by retail and institutional investors were the same (2.8%), retail daily redemptions were more volatile, with a standard deviation of 1.9% as compared to 1.4% for institutional investors. Average daily redemptions by institutional omnibus accounts were only 2.1%, however, and were more regular than retail daily redemptions, with a standard deviation of just 1.0%.*

This data demonstrates that, for at least one complex, institutional investors are not more prone to "run" from an MMF than retail investors. There is no data demonstrating that a floating NAV will staunch runs. It should not be required of any type of MMF. In any event, "institutional" is too broad a classification for implementing a policy based on an investor's propensity to redeem.

- Should MMFs be required to mark-to-market all assets in their portfolios under this option and be limited in using the amortized cost method of valuation to the same extent as other mutual funds? Why or why not?

    - If the SEC required MMFs to use floating NAVs like other mutual funds, should it nonetheless continue to permit different valuation practices regarding portfolio securities for MMFs versus other mutual funds?

    - How effective would this be during times of stress, when markets for such securities may be less liquid or transparent?

As discussed in detail in Arnold & Porter's January 25, 2013 comment on the floating NAV proposal, MMFs cannot "mark to market" all assets in their portfolios because unlike equity securities, for which there are readily available market prices, many of the instruments held by MMFs, such as commercial paper, do not trade daily and do not have daily market *prices. Instead, these instruments are priced at their "fair valuation" – a reasonable estimate of the price at which the instrument could be sold in a current trade.*

In practice, MMFs have elaborate and rigorous procedures to obtain valuations for their portfolio assets and to measure deviations between the MMF's amortized cost price per share and the "current net asset value per share" as that term is defined in SEC regulations. Virtually all MMFs engage independent pricing services to get to a high degree of comfort that the valuations identified by these services for each instrument held in portfolio appropriately "reflect current market conditions." MMF internal valuation experts closely monitor any deviations from the valuations obtained using amortized cost accounting.

For those instruments that do not trade on a daily basis, pricing services generally use what is known as "matrix" pricing: the pricing service compares each individual instrument within the portfolio to a homogenous set of instruments in the market (e.g., because they have similar ratings, interest rates, maturities) to derive a valuation. While matrix pricing is mechanistic and may be an "appropriate substitute" where there is no mark-to-market price, different pricing services may arrive at very minute differences in prices for a portfolio asset, depending upon instruments used as reference points. Each MMF board has the ultimate responsibility to assure that valuation methods used (whether by a pricing service or otherwise) are appropriate. It is this valuation method that MMFs use to arrive at a "shadow price" to compare against the amortized cost valuations. It is an important benchmark, but it is, like amortized cost valuation, a type of fair valuation and is not "mark-to-market." Because the valuations derived under this method are virtually identical to, or very similar to, valuations derived using amortized cost, amortized cost is a more efficient and reliable means of pricing MMF portfolio assets.

- Should a floating NAV requirement be combined with any other regulatory reform options, such as redemption restrictions, to further lessen funds' susceptibility to runs? If so, which restrictions and why?

No. For the reasons discussed in Arnold & Porter's three comment letters of January 25, 2013, the Council should not recommend that the SEC adopt the floating NAV, the minimum balance at risk, the capital buffer, or any combination of those requirements.

- How would floating the NAV affect investor demand for MMFs?
    - To what extent and why would investors discontinue investing in MMFs if they operated with a floating NAV?
    - Where would investors shift their investments and how would this mitigate or increase risks to financial stability?

Daily liquidity at par is a hallmark feature of MMFs. As discussed in detail in Arnold & Porter's January 25, 2013 comment on the floating NAV proposal, many MMF investors would have no choice but to divest their MMF shares due to current statutory and/or investment *restrictions on investing in floating NAV funds. Other investors would leave the funds because of the tax, accounting, and costly operational burdens that undermine the utility of MMFs for particular users. In its comment letter dated April 19, 2012, the ICI submitted a detailed survey from Treasury Strategies demonstrating that the extent of divestment by corporate treasurers would be substantial. As a result, investors would shift investments to less-transparent, less-regulated cash management products or to systemically important banks, either of which shifts would increase systemic risk.*

II. Questions Relating to Alternative Two: NAV Buffer and Minimum Balance at Risk.

The questions below relate to the Council's second alternative, which would require MMFs to hold capital to serve as an "NAV buffer" of up to 1 percent based on the nature of the fund's assets,[5] paired with a minimum balance at risk (MBR) requirement. The MBR would require that 3 percent of a shareholder's highest account value in excess of $100,000 over the prior 30-day period be held back (not available for redemption) for a period of 30 days. The Release states that the capital would absorb day-to-day fluctuations in the value of the funds' portfolio securities and allow the fund to maintain a stable NAV. In the event that an MMF suffers losses that exceed the capital, the losses would be borne first by the MBRs of shareholders who have redeemed in the 30 day period prior to the loss. The Release says this will create a disincentive to redeem and provide protection for shareholders who remain in the fund. The MBR requirement would not apply to investors with account balances below $100,000. Treasury MMFs would not be required to maintain any capital.

The Release states that an MMF would be permitted to use any funding method or combination of methods to build the required capital. It identifies three possible funding methods: contributions from an MMF sponsor held in escrow; issuance of a class of subordinated equity securities, sold to third parties or purchased by the sponsor; and retention of earnings by an MMF. The buffer may be built up over a two-year period.

According to the Release, the Council believes the NAV buffer and MBR would reduce the first-mover advantage, make explicit a sponsor's support of a fund, impose additional discipline on fund managers by requiring changes in portfolio management if the NAV buffer falls below required levels, permit funds to sell distressed securities more easily, force redeeming shareholders to share in losses caused by redemptions (and thus discourage them from redeeming during periods of stress), and provide protection for non-redeeming shareholders during periods of stress. The Release acknowledges that the NAV buffer would reduce investor yields, present operational and/or technology costs, potentially present regulatory capital problems for sponsors, and could reduce investor demand for MMFs. It also states that the MBR "likely would not be sufficient to stop a run on an MMF if investors anticipate very large losses" or stop a run on other funds if investors anticipated that large losses would be incurred across funds.

The Council requests comment on the NAV buffer/MBR alternative as well as on all aspects of the discussion contained in the Release. The Council also requests any quantitative analysis or data from commenters relating to this alternative. The Release asks for comment on following additional questions:

- Would requiring most MMFs to maintain NAV buffers and MBRs make the funds less susceptible to runs?

[5] No capital would be held against cash, Treasury securities, and Treasury repos; .75 percent capital would be held against other daily liquid assets (or weekly liquid assets in the case of tax-exempt funds); 1.00 percent capital would be held against all other assets.

No. The Council's proposition that an investor, when faced with the possible closure of a troubled fund, will forgo immediate access to cash in order to avoid a small loss of principal, is sheer conjecture, and wholly at odds with evidence concerning the behavior of investors in a financial crisis. Arnold & Porter's January 25, 2013 comment on the Minimum Balance at Risk and NAV Buffer proposal provides great detail on this issue.

 - Would this alternative reduce the potential financial instability associated with MMFs?

The Council has not demonstrated that there is "potential financial instability" associated with MMFs. In any event, survey data and other commentary cited in Arnold & Porter's January 25, 2013 comment letter strongly suggest that an MBR/NAV buffer requirement could be destabilizing and could trigger preemptive runs under certain circumstances, thereby increasing systemic risk.

- Would this alternative make MMFs more resilient by replacing the rounding conventions currently provided by rule 2a–7 with a transparent and prefunded NAV buffer?

No. The buffer is not feasible in the current rate environment and is not feasible for investors or sponsors to fund over time. Moreover, the illusion of protection could undermine market discipline for both managers and investors or be destabilizing, as discussed above.

- Would the buffer requirement help foster discipline for fund managers?

No. As discussed in Arnold & Porter's January 25, 2013 comment on the MBR/Capital proposal, MMF managers are already subject to the discipline of managing to a stable NAV without the "net" of any capital buffer. MMF sponsors are further disciplined by the knowledge that a misjudgment could result in a cost to the sponsor, reputational damage (and consequent loss of assets as shareholders redeem) or closure of the fund if its valuation drops only 1/2 of one cent per share. If the effect of the buffer is to assure investors that an MMF is safer and/or that the $1.00 per share price is supported by capital, it would undermine discipline.

- Would it reduce the uncertainty for investors caused by the current reliance on sponsor support to absorb minor losses in MMF portfolios?

No. Investors will not be assured (nor should they be) that a capital buffer will absorb losses of a MMF. Moreover, the current uncertainty of MMF investors regarding sponsor support, in addition to investors' knowledge that MMFs operate without a capital buffer, avoids moral hazard and acts as a discipline on MMF investors to monitor MMFs. Finally, we are unaware of any data suggesting that investors rely on sponsor support. In its 2010 rule release, the SEC itself said that they do not. Money Market Fund Reform, 75 Fed. Reg. 10060, 10087 (Mar. 4, 2010).

 - Would such uncertainty be maintained if sponsors, on a discretionary basis, provided financial support to prevent material decline of the required NAV buffer?

There is no reason to alter current law, which permits sponsors to take certain actions regarding a MMF in the best interests of shareholders.

- The Council requests comment on many facets of the NAV buffer, including:
    - Should MMFs be required to maintain an NAV buffer of a different size?

Arnold & Porter addressed the efficacy of a NAV buffer in its submission of January 25, 2013. Extensive discussions regarding the impact of a NAV buffer are also included in our letter to the SEC dated February 24, 2011, a letter to the SEC by Federated Investors dated May 6, 2011, in an ICI report submitted to the SEC on May 16, 2012 ("The Implications of Capital Buffer Proposals for Money Market Funds"), and in the ICI's letter dated January 24, 2013.

As discussed in those comments and below, a NAV buffer would result in multiple indirect and direct costs, each of which would increase with the size of the buffer. In terms of indirect costs, a NAV buffer could exacerbate run risk at MMFs because it would confuse some investors as to the nature of the product and foster a belief that their shares are guaranteed. It also could encourage investors to rely on the NAV buffer rather than their own diligence when deciding whether to buy or redeem an MMF's shares. The NAV buffer would thus encourage risk-averse investors to invest in MMFs. This could increase volatility and the likelihood of a run on MMFs. MMF advisers may engage in more risky strategies to recover costs of building a buffer. These undesirable motivations of investors and advisers would increase with the size of the buffer.

The direct costs of imposing a NAV buffer would also increase with the buffer's size. According to analyses by the ICI, if a buffer of 1.5 to 3 percent were to be required to be supplied by fund sponsors, it would take every dollar of at least 8 to 20 years of the advisers' profits in order to recoup the cost. On the other hand, if a prime MMF were required to fund the buffer from withheld shareholder yield, ICI calculated it would take a prime MMF 10 to 15 years to raise just a 0.5 percent buffer. In a third alternative, if advisers attempted to earn a market rate on invested capital through increased fees, according to ICI those fees would have to rise in the range of 16 to 40 basis points, which investors would not tolerate. Given these costs – which would be especially burdensome to new entrants – prime MMFs would no longer be economically viable products.

A buffer's cost cannot be passed on to prime MMF investors. Current yields on prime funds are between 1 and 5 basis points, whereas Treasury MMFs often have 0.00% yields.[6] *If attempts are made to pass on these costs, investors will seek other investment vehicles, as there is no reason to invest in a prime MMF when the investor can get the same yield in a Treasury MMF.*

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[6] Crane Data, *Money Fund Intelligence Daily Data* (last visited Feb. 13, 2013) (showing MMF prime and Treasury yields as of Feb. 12, 2013).

- When combined with an MBR requirement, should the NAV buffer be larger or smaller?

The Council should not recommend the NAV buffer, MBR requirement or any combination thereof.

- Should the NAV buffer requirements applicable to various types of MMF portfolio assets be different?

The Release proposes that no capital requirement be imposed on Treasury securities and that no capital requirement apply at all to Treasury MMFs. A number of commenters (Arnold & Porter's letter of January 25, 2013 on the capital proposal, ICI's letter of January 24, 2013, Federated's letter of January 30, 2013, and BlackRock's letter of December 13, 2012) have all pointed out that a capital requirement imposed on prime funds (assuming they could sustain the costs) would lower yields to at or below Treasury MMFs, distorting capital flows and crowding out private borrowers.

- Should funds have the flexibility to raise the NAV buffer through a variety of funding methods? If not, which methods should funds be required to use and why?

- What governance, incentive, and other concerns are raised by each method of funding a buffer?

- Are there additional funding methods that would require relief from the SEC, or particular methods that the SEC should preclude?

- Could additional types of buffer shares, other than equity securities, be used to create an NAV buffer?

These questions reflect the Council's preconception that MMFs should be regulated as if they were banks, and evidence a disregard for the principles that underlie the securities laws. In brief, banks are subject to rules that govern the amounts and form of capital that they must maintain because bank deposits are federally insured, generally short-term debt obligations that are issued against portfolios of high-risk, non-transparent, illiquid, and generally medium- and long-term loans and other assets. These portfolios are subject to substantial interest rate, funding, and credit risk. MMFs, on the other hand, are mutual funds – uninsured investment products owned by shareholders, who bear the risk of loss. As such, they are subject to laws and regulations that preserve other interests: transparency, the mitigation of conflicts of interest, avoidance of leverage, and the fair treatment of shareholders.

Creating a two-class share "buffer" structure for a MMF subverts the pattern of mutual fund regulation. Indeed, it is prohibited under Sections 1(b) and 18 of the Investment Company Act, and is contrary to the legislative findings and purposes behind that Act to prevent the conflicts of interest among different stakeholders that necessarily follow from leveraged or multi-class capital structures. The SEC would need to waive this fundamental prohibition in order to *permit the two-class capital structure. On the other hand, if retained earnings are to be used to create the capital buffer, this method conflicts with several valuation and accounting requirements codified in the Investment Company Act, which also would need to be waived by the SEC. As the ICI has stated "[a]dding subordinated debt or equity would turn a rather simple product—the money market fund—into a considerably more complex offering . . . . [T]he approach potentially would create competing interests between the subordinated and senior investors, such as the subordinated investors' desire to avoid losses and senior investors' desire for the fund to take greater risks to boost fund yields. A market-raised capital buffer would reduce the yield available to senior shareholders, and subordinated investors would have a highly levered investment." Similarly, as explained in Arnold & Porter's submission of January 25, 2013 on the MBR proposal, an MBR requirement would be inconsistent with state laws or corporate charters that require equal treatment of redeeming and remaining shareholders.*

Finally, to implement these changes at existing MMFs (including the resulting changes to advisers' fees), it would be necessary to obtain MMF board approval, provide notice and disclosure to existing investors and obtain approval of the changes by shareholder vote, and amend the prospectuses and registration statements of the MMFs. There are significant costs involved in this process, including legal and accounting fees, documentation costs, printing, mailing, use of proxy solicitors and other steps needed to bring the matters to a vote.

- Would some sponsors' cost advantage in providing their funds' NAV buffers give competitive advantages to their MMFs?

- If so, how would this affect the financial instability associated with MMFs?

- How could the SEC design an NAV buffer requirement to mitigate any such competitive advantages? Should the SEC, for example, mandate that the NAV buffer could be raised only through a combination of the issuance of buffer shares and a fund's retention of earnings, because these methods of funding potentially would be available to all MMFs?

Large fund sponsors will undeniably have an advantage over small, new, or independent ones in the implementation of a capital requirement. Ironically, the largest fund sponsors are primarily the largest "too big to fail" banks. If small fund sponsors exit the business – and they will – the inevitable result will be further concentration of assets and risk. Even larger fund sponsors that are not affiliated with banking entities will face increased pressures because they lack alternative sources of funds to capitalize the buffer.

We doubt that the SEC or any regulator could design a NAV buffer requirement that would mitigate such competitive advantages. Third party capital will not be available for subordinated shares. Attempting to build capital through retained earnings will take years, and, in any event, will make prime funds noncompetitive with Treasury MMFs.

- Is the contemplated NAV buffer phase-in appropriate? If not, should it be shorter or longer?

The contemplated two-step phase-in period (one half of the buffer in place after one year, full buffer after two years) is woefully short. The ICI has calculated that if a prime MMF were required to fund the buffer from withheld shareholder yield, it would take 10 to 15 years to raise just a 0.5 percent buffer. Similarly, a*ccording to the ICI's analysis, if a buffer of 1.5 to 3 percent were to be required to be supplied by fund sponsors, it would take every dollar of at least 8 to 20 years of the advisers' profits in order to recoup the cost. Given these estimates and the current interest rate environment, the two-step phase-in period is insufficient to allow a buffer to be implemented.*

- The Council requested comment on many facets of the MBR requirement, including:

    - Would the MBR requirement make MMFs more resilient by requiring some redeeming investors to remain partially invested in an MMF for 30 days?

No. The Council's proposition that an investor, when faced with the possible closure of a fund, will forgo immediate access to cash in order to avoid a small loss of principal, is sheer conjecture, and wholly at odds with evidence concerning the behavior of investors in a financial crisis. Arnold & Porter's January 25, 2013 comment on the MBR and NAV Buffer proposal provides great detail on this issue.

- Would a 3 percent MBR be sufficiently large to mitigate the risk of runs on MMFs?

It will precipitate, not mitigate, the risk of runs. An MBR of any size is punitive will make MMFs so unattractive to investors that they will leave the product.

- Should be it be larger or smaller?

See above.

- Should the length of the redemption delay be longer or shorter than 30 days?

A delay of any length could precipitate preemptive runs. This issue is discussed, along with surveys and data, in Arnold & Porter's letter of January 25, 2013.

- Does a 3 percent MBR with a 30-day redemption delay appropriately balance the objectives of reducing the vulnerability of MMFs to runs without burdening unnecessarily the funds and their shareholders? Does it preserve the role of redemptions in providing market discipline for MMFs?

As discussed in detail in Arnold & Porter's January 25, 2013 comment letter on the MBR proposal, it will not reduce the risk of runs, it may precipitate preemptive runs, it will make the product sufficiently burdensome and unattractive that investors will not invest in a MMF with MBR features, and it will undermine market discipline.

- Should each investor's MBR be a portion of its High Water Mark, a portion of the average of the investor's balance over the previous 30 days or some other period, or some other measure?

The concept is too complicated to be implemented by intermediaries; investors will reject a product that prevents them from accessing all of their money.

- Would an alternative approach toward subordination be more effective?

As discussed in Arnold & Porter's January 25, 2013 comment letter on the MBR proposal, the subordination feature is wholly unfair to redeeming shareholders, many of whom will not be redeeming for the purpose of "running" from an MMF but simply redeeming in the ordinary course of business.

- Are the exemptions from the NAV buffer and MBR requirements for Treasury MMFs appropriate? Should the SEC provide exemptions for other types of funds?

Investors will not invest in a MMF with MBR/capital requirements. If Treasury MMFs are exempted and other funds are subject to the requirements, investors will use Treasury MMFs but not others, which will contribute to a crowding out of capital for private issuers.

- Some retail investors—those with balances of less than $100,000—would not be subject to the MBR requirement because retail investors may be less likely to participate in a run.
  - Are retail investors less likely to participate in a run?

Federated's experience is that retail investors are not less likely to redeem in a crisis. They may be likely to redeem later when they have more information, but they may nonetheless redeem in a crisis. As discussed above, Federated addressed this issue in detail in its September 8, 2009 comment letter to the SEC on its proposed rulemaking.

As proposed, the MBR would probably result in every shareholder, retail and institutional, immediately redeeming $100,000 from their account, as this would not subject them to subordination. The resulting large-scale redemption could trigger a run on the fund.

  - Would MMFs consisting primarily of retail investors not subject to an MBR requirement be at increased risk?

No. Nor would MMFs consisting primarily of institutional investors.

  - Is it appropriate to define a retail investor for this purpose by reference to the size of the investor's account? If so, should the threshold be $100,000, or should it be higher or lower, and why? If not, what other characteristics would be more appropriate?
  - How would MMFs apply this exemption to omnibus accounts?

  - Should MMFs be required to have transparency through these accounts to apply the exemption?

Any amount will be arbitrary and will continue to punish investors who hold assets in excess of that amount. In any event, the MBR would be virtually impossible to apply to omnibus accounts. The complexity and uncertainty will cause investors to leave MMFs for simpler and fairer alternatives.

- Should the SEC provide an exemption from the MBR for redemptions made in accordance with a plan that a shareholder has provided to the fund in advance?

  - If so, how far in advance should a shareholder be required to notify the MMF of the shareholder's redemptions plans in order to prevent the shareholder from using the exemption to avoid redemption delays when MMFs are under stress?

This question reflects the inequity of the MBR. The MBR is designed to punish shareholders for exercising their legal right to redeem their shares. Redemptions are not always motivated by the desire to avoid losses, however; redemptions also result from the shareholder's need to use the money for a planned expenditure. In fact, because a MMF is so rarely at risk of breaking a dollar, redemptions are nearly always driven by the shareholder's financial needs.

Consequently, many redemptions are "planned" in some sense. A corporate treasurer plans to redeem shares to make payroll, service debts, pay taxes or distribute a dividend. An indenture trustee plans to redeem shares to make scheduled interest coupon and sinking fund payments. An individual plans to redeem shares to make monthly mortgage and car loan payments or to pay for utilities and other regular bills. A broker plans to redeem shares from its customers sweep account to settle a purchase trade. None of these shareholders is seeking a "first-mover advantage" by redeeming their shares, yet the MBR would apply equally to their redemptions.

Creating an exception for "planned" redemptions would add to the already overwhelming recordkeeping burdens of the MBR. Shareholders could send in their cash flow budgets, which the MMFs would have to maintain and compare to each redemption. There would be no practical way to implement such an exception.

More importantly, motivation is irrelevant to the equitable treatment of shareholders. In normal circumstances, when a MMF is not threatened with breaking a dollar, redemptions are innocuous, regardless of their motivation. Imposition of an MBR in such circumstances would impose a cost with no corresponding benefit to shareholders. In the rare instance when a MMF is in danger of breaking a dollar, "planned" redemptions are just as dilutive as spontaneous redemptions. Unless the sponsor chooses to intervene, this circumstance is better addressed by suspending redemptions or having the fund break a dollar than by imposing an MBR.

- Are there ways to reduce the operational and other costs associated with implementing the NAV buffer and the MBR?

- What is a realistic timeframe for implementation of these changes from an operational perspective?

- Who would bear these one-time and recurring costs?

- Would these costs end up being absorbed by fund sponsors, financial intermediaries, or investors in these funds?

- To what extent would these costs affect MMF sponsors' willingness to offer non-Treasury MMFs under this alternative?

- To what extent are the costs associated with the NAV buffer new costs, as opposed to costs that have been borne by some fund sponsors?

Investors and intermediaries will not use products with an MBR. As discussed in detail in Arnold & Porter's letter of January 25, 2013 on the MBR proposal, the MBR requirement would require funds and intermediaries to compile and track a vast amount of data. It would require daily computation of free balance information (based on the high water mark for the prior 30 days and the balance in the account) for every account for every business day during the 30-day delay period. The requirement also poses significant operational challenges and costs for omnibus accounts, sweep accounts, and other uses involving intermediaries and systems that extend beyond the control of MMFs themselves. These impacts were described by DST Systems, Inc. in a March 2, 2012 letter to the SEC. The requirement would add layers of costs and complexity to a range of systems that currently use MMFs to hold short-term cash balances, including: corporate payroll processing; corporate and institutional operating cash balances; bank trust accounting systems; federal, state and local government cash balances; municipal bond trustee cash management systems; consumer receivable securitization cash processing; escrow processing; 401(k) and 403(b) employee benefit plan processing; broker-dealer customer cash balances; futures dealer customer cash balances; investment of cash collateral for cleared and uncleared swap transactions; cash-management type accounts at banks and broker-dealers; portfolio management; and 529 plans.

Moreover, while the MBR/subordination requirement has been promoted as a way to promote fairness to investors by eliminating "first-mover" advantages, the requirement in fact would penalize any shareholder who needs to redeem an amount in excess of the available balance at any time, even if the investor is simply redeeming in the normal course. This would be a particularly costly burden for the many businesses use MMFs to hold cash balances for corporate payroll processing or hold other cash balances generated from receivables and operations to meet payment obligations as they arise.

The MBR rule's impact on costs, yields and liquidity would penalize all MMF shareholders all of the time, however it is implemented. Shareholders are likely to find the arrangement intolerable and opt for alternative investments.

- How would the combined effects of any reduction in yield from the NAV buffer and inconvenience caused by restrictions on redemptions from the MBR affect investor demand for MMFs?
  - To what extent and why would investors discontinue investing in MMFs subject to these requirements?
  - If a reduction in demand is anticipated, to which other investment vehicles would investors most likely shift money?
  - What would be the net effect on financial stability?

Investors and intermediaries will not use products with a combined MBR/NAV buffer. Many will be prevented from doing so because of statutory or prudential requirements that mandate equal treatment of redeeming and remaining shareholders. In its comment letter dated April 19, 2012, the ICI submitted to the SEC docket a detailed survey from Treasury Strategies which found that one-third of corporate treasurers were subject to such restrictions, and that over half would discontinue use of MMFs entirely if the funds were subject to an MBR requirement. Retail users likely would also abandon MMFs in favor of alternative cash management products that are less burdensome than an MMF with an MBR/NAV buffer. Investors would shift investments to less-transparent, less-regulated cash management products or to too-big-to-fail banks, either of which would increase systemic risk.

III. Questions Relating to Alternative 3: Risk-Based 3% Capital Requirement.

The questions below relate to the proposal for a 3% risk-based capital requirement for MMFs. According to the Release, the purpose of the capital is to absorb day-to-day variations in the mark-to-market value of MMFs' portfolio and to reduce investor incentives to redeem shares when a fund encounters stress. Certain MMF assets would be exempt from the capital requirement; certain assets would be subject to a reduced capital level.[7] Under the Release, capital could be raised from a MMF sponsor, who could establish and contribute assets to an escrow account pledged to support the fund's NAV; from retained earnings that it would otherwise distribute to shareholders; or from issuance of a subordinated class of equity securities that would absorb first loss and that could be sold to third parties or purchased by the fund's sponsor or affiliates. Treasury funds would not be subject to the capital requirement. The Release states that, "while the NAV buffer may reduce the probability that an MMF investor suffers losses, it is unlikely to be large enough to absorb all possible losses and may not be sufficient to prevent investors from redeeming when they expect possible losses in excess of the NAV buffer."

The Council requests comment on this alternative as well as on all aspects of the discussion presented above. The Council also requests any quantitative analysis or data from commenters relating to this alternative. Following the questions immediately below, the Release then discusses and asks questions about "additional measures that may complement the NAV buffer in mitigating run vulnerabilities." Those questions are set forth further below, in section IV.

- The Council seeks comment on the size of the NAV buffer.
  - Should the NAV buffer be larger or smaller?
  - Does a larger NAV buffer address the structural vulnerabilities of MMFs described in the Release?

Arnold & Porter addressed the efficacy of a NAV buffer in its submission of January 25, 2013. Extensive discussions regarding the impact of a NAV buffer are also included in our letter to the SEC dated February 24, 2011, a letter to the SEC by Federated Investors dated May 6, 2011, in an ICI report submitted to the SEC on May 16, 2012 ("The Implications of Capital Buffer Proposals for Money Market Funds"), and in the ICI's letter of January 24, 2013.

As discussed in those comments and below, a NAV buffer would result in multiple indirect and direct costs, each of which would increase with the size of the buffer. In terms of indirect costs, a NAV buffer could exacerbate run risk at MMFs because it would confuse some investors as to the nature of the product and foster a belief that their shares are guaranteed. It also could encourage investors to rely on the NAV buffer rather than their own diligence when

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[7] No capital would be held against cash, Treasury securities, and Treasury repos; 2.25 percent capital would be held against other daily liquid assets (or weekly liquid assets in the case of tax-exempt funds); and 3.00 percent capital would be held against all other assets.

deciding whether to buy or redeem an MMF's shares. The NAV buffer would thus encourage risk-averse investors to invest in MMFs. This could increase volatility and the likelihood of a run on MMFs. MMF advisers may engage in more risky strategies to recover costs of building a buffer. These undesirable motivations of investors and advisers would increase with the size of the buffer.

The direct costs of imposing a NAV buffer would also increase with the buffer's size. According to analyses by the ICI, if a buffer of 1.5 to 3 percent were to be required to be supplied by fund sponsors, it would take every dollar of at least 8 to 20 years of the advisers' profits in order to recoup the cost. On the other hand, if a prime MMF were required to fund the buffer from withheld shareholder yield, ICI calculated it would take a prime MMF 10 to 15 years to raise just a 0.5 percent buffer. In a third alternative, if advisers attempted to earn a market rate on invested capital through increased fees, according to ICI those fees would have to rise in the range of 16 to 40 basis points, which investors would not tolerate. Given these costs – which would be especially hard on new entrants – prime MMFs would no longer be economically viable products.

A buffer's cost cannot be passed on to prime MMF investors. Current yields on prime funds are between 1 and 5 basis points, whereas Treasury MMFs often have 0.00% yields.[8] *If attempts are made to pass on these costs, investors will seek other investment vehicles, as there is no reason to invest in a prime MMF when the investor can get the same yield in a Treasury MMF.*

- o What type of analysis of MMF portfolio exposures should be undertaken when considering an appropriate size for the NAV buffer?

MMFs already hold highly liquid, short duration, high quality assets, and are highly diversified and subject to extensive risk management requirements, including requirements to understand and manage the liquidity needs of investors. A capital buffer would be overkill and unnecessary.

- How would this higher NAV buffer impact investors, short-term financing markets, and long-term economic growth?
  - o How would the NAV buffer requirement, and particular MMF's choices of buffer funding methods, affect MMFs' yields?
  - o To what extent would an NAV buffer funded solely through buffer shares and the retention of earnings affect a MMF's yield?
  - o Could it cause a prime MMF's yield to decrease below those offered by government or Treasury MMFs? In what circumstances could this occur and how

[8] Crane Data, *Money Fund Intelligence Daily Data* (last visited Feb. 13, 2013) (showing MMF prime and Treasury yields as of Feb. 12, 2013).

likely is it to occur?

As discussed in Arnold & Porter's letter of January 25, 2013 and Federated's letter of January 30, 2013, the proposed capital buffer of 1% under Alternative 2 or 3% under Alternative 3 cannot realistically be raised by third parties. This subordinated capital would be junior to common equity; subordinated shares would only participate in losses, not gains and would have no control over MMF's directors; and we do not believe anyone would provide MMFs with capital on these terms nor do we believe the Release's projected required return is even remotely realistic. Equally unrealistic is the proposition that capital could be built from withholding investor yields. As discussed in Federated's letter, given that prime MMFs are currently yielding from 1 to 5 basis points, it would take over a hundred years to build the capital cushion required under Alternative 3 by withholding income from shareholders. This means sponsors are the only realistic sources of capital, but prime MMFs currently do not earn enough to compensate anyone for the capital that would be required, they not have the market power to increase rates paid for funding provided by MMFs, nor can they pass on costs to MMF shareholders currently earning single digit yields. These issues are discussed extensively in Federated's January 30, 2013 letter, as well as the comments provided by the ICI and Arnold & Porter, among others.

A reduction of prime funds' yield in even a small amount will cause investors to shift assets from prime MMFs to government or treasury MMFs. According to BlackRock's letter of March 2, 2012, "assuming a 6-basis point charge to the fund, prime funds' yields would have been lower than government funds' more than 1/3 of the time. Looking forward, this relationship is sensitive and could result in substantial flows of capital among funds, thereby destabilizing the industry."

- The Council also requests comment on the design and duration of the transition period to implement the NAV buffer.
    - How long should the transition period be?
    - Should the transition period be based on economic or market conditions rather than a pre-determined phase-in deadline?

As discussed above and in letters to the Council (ICI's letter of January 24, 2013, Arnold & Porter's letter of January 25, 2013, and Federated's letter of January 30, 2013), given the sources of capital the Council has identified, no realistic transition period could be developed to accommodate the buffer proposal. Capital cannot realistically be raised through third parties. It would take over a hundred years to build the capital cushion required under Alternative 3 by withholding income from shareholders and decades to raise lesser amounts. Sponsors would be more likely to exit the business than to commit capital at sub-market returns. Unless interest rates rise precipitously, no amount of transition period will alter this economic reality.

- How would the larger NAV buffer in Alternative Three, alone or combined with investment diversification requirements and other measures as discussed below, affect investor demand for MMFs?

- To what extent and why would investors discontinue investing in MMFs subject to these requirements?

- Where would investors shift their investments and how would this mitigate or increase risks to financial stability?

As discussed above, the proposed capital requirement could not be raised from third parties, investors, or sponsors. Third parties simply would not provide the necessary capital. Sponsors would be unable to pass on costs to investors and would exit the business. Investors would then shift investments to less transparent, less regulated cash management products or to too-big-to-fail banks, either of which would increase systemic risk.

- When considering the larger NAV buffer in Alternative Three, what mix of other measures described below can most effectively complement the NAV buffer?

  - To the extent that more stringent investment diversification requirements reduce MMFs' vulnerabilities, as discussed below, could such requirements be combined with a lower minimum NAV buffer and, if so, what would be the appropriate minimum?

  - Could other measures be combined with more stringent investment diversification requirements to provide additional protections?

  - Should the Council consider additional risk-based tailoring of the NAV buffer, for instance, based on specific types of MMF assets?

  - Should the required NAV buffer be larger for MMFs with more concentrated exposures, particularly those to financial institutions?

Whether the capital buffer is 1% or 3%, it would be unwarranted and cost-prohibitive. Moreover, adding diversification requirements beyond the stringent standards of Rule 2a-7 may cause fund managers to invest in issuers that they deem less creditworthy, thus increasing *systemic risk. Nor should the Council recommend additional requirements for the NAV buffer that would depend on the type of assets held by the MMF. Such an approach would shrink investments by MMFs in certain assets in order to avoid the additional buffer requirements, with consequences in the form of higher funding costs for issuers of those assets. For example, private sector issuers of commercial paper would have to pay higher interest rates in order to attract short-term funding.*

IV. Questions Regarding Possible Complementary Measures To A Risk-Based Capital Requirement.

The Council's proposal for a risk-based 3% capital requirement contemplates possible additional measures for the purpose of "mitigating run vulnerabilities." The measures discussed in the Release include (a) more stringent diversification requirements, (b) increased minimum liquidity, (c) enhanced investor transparency, and (d) more robust disclosure. According to the Release, these measures "individually would likely not significantly alter the activities and practices that make MMFs vulnerable to runs." The Release states that the Council's final recommendation could include these additional measures, which could act to reduce the size of the required capital requirement.

More Stringent Diversification Requirements.

The Release notes that Rule 2a-7 allows an MMF (other than a single-state fund), to invest up to 5 percent of its assets in securities issued by one issuer. It requests comment on two potential changes to the Rule: (i) reducing the 5 percent limitation; and (ii) revising the definition of "issuer" to include all affiliates of a consolidated group. The Release states that more stringent diversification requirements, "particularly when paired with a material NAV buffer," could allow MMFs to better withstand defaults. The Council solicits general comment on more stringent diversification requirements, and raises the following points:

- Could more stringent diversification requirements materially reduce the amount of funding that MMFs provide to larger issuers?

Yes. Either of the proposed changes to the 2a-7 diversification requirements would require MMFs to decrease investments in any given issuer. Absent an increase in the number of MMFs to supply funding, this could reduce the amount of funding MMFs provide to larger issuers, especially higher quality issuers.

- Could they result in MMFs investing in less creditworthy issuers?

Yes. Either of the proposed changes to the diversification requirement will decrease the exposure an MMF may have to any particular issuer, no matter how creditworthy. This means that an MMF would be required to move the overage into other issuers in which it otherwise would not have invested.

- Could they cause MMFs to withdraw funding from the financial system and instead invest in less-risky securities (such as Treasury securities) that are not subject to diversification requirements?

Some fund managers might choose to invest the excess in U.S. government securities, while others might (as we have noted) invest in lower-quality issuers. In either case, the change would reduce the amount of short-term financing that MMFs provide to high-quality private-sector issuers. A shift to purchases of Treasury securities would also result in a "crowding out" *effect, where available funding will flow to the government, and funds available for lending to the private sector will decrease. This issue is discussed in Federated's letter of January 30, 2013.*

- What impact would these changes have on large issuers and short-term funding markets?
  - To the extent that MMF investments are constrained or reduced in response to these restrictions, in what types of securities would MMFs invest?

More stringent diversification requirements, especially if paired with a capital requirement, would have the effect of reducing the amount of short-term credit available for large issuers, and the concomitant effect of making that funding more expensive. MMFs would change their investment patterns by investing in lower quality private issuers or in government securities or (depending on regulations) securities issued by states or municipalities.

- At what level should issuer diversification requirements be set?
  - Does adopting a "cover one" methodology — whereby each MMF would have sufficient loss absorption capacity to mitigate the failure of its largest investment — provide adequate protection to MMFs?
  - How should these standards be compared to those used in other regulatory contexts?

As stated in Arnold & Porter's January 25, 2013 letter on the proposed capital requirement, we believe it is appropriate for the SEC to periodically consider changes to the risk-limiting provisions of 2a-7, including diversification requirements. We believe the heightened diversification requirements put in place in the SEC's 2010 amendments to Rule 2a-7 (under which MMFs are not permitted to acquire more than one half of one percent of their assets in second tier securities of any particular issuer, and are otherwise capped at five percent in other securities from any single issuer) strike an appropriate balance between diversification and credit quality. As the SEC pointed out in its 2010 release, a limitation of one half of one percent for all issuers may "expose the fund to investing in securities of lower credit quality." 75 Fed. Reg. 10060, 10065.

The current diversification standards of Rule 2a-7 may be compared to the regulations of the Comptroller of the Currency governing Short-Term Investment Funds (STIFs), which are collective investment funds that are managed by banks, that use amortized cost accounting and seek to maintain a stable share price of $1.00 per share. Despite the fact that at least three STIFs "broke a buck" and incurred substantial portfolio losses on imprudent investments during the Financial Crisis and were participants in the Federal Reserve's lending programs, these amended regulations do not feature specific restrictions on concentration of investments in specific issuers. They were only recently amended to require banks that manage STIFs to adopt plans that include such restrictions. Short-Term Investment Funds, 77 Fed. Reg. 61229 (Oct. 9, *2012). Thus, even as amended, the Comptroller's rules allow bank managers to exercise some judgment in their issuer concentration levels. If the Comptroller (who is a member of the Council) deems that STIFs are adequately regulated under such a permissive standard, then it is difficult to understand why MMFs should be subject to stricter diversification requirements than the specific ones that apply to them today.*

- Should these standards be applied differently to different types of MMFs (for instance, prime, government, and tax-exempt MMFs)?

As discussed above, the current diversification requirements are sufficient.

- What changes, if any, should be made with respect to the diversification requirements for demand features and guarantees?

None. The 2010 amendments to Rule 2a-7 appropriately limited an MMF's potential exposure to any particular demand feature provider or guarantor by putting in place stricter requirements regarding second tier securities.

  - o Should diversification limits apply to credit enhancements other than guarantees and demand features?

Rule 2a-7's definitions of "guarantee" and "demand feature" are very broad. The Council will need to be more specific about the types of credit enhancements to which this question refers.

- What changes should be made, if any, to the definition of "issuer" in the context of issuer diversification requirements?

  - o Are there other changes to the issuer diversification calculations that would further strengthen these reforms? For example, should diversification requirements for asset-backed securities generally treat as the issuer of the securities the special purpose entity that issued them, the sponsor of the asset-backed securities, or the issuers of the securities underlying the asset-backed securities?

The suggested treatments of asset-backed securities for diversification purposes were all considered in connection with the reforms adopted by the SEC in 1996 and modified in 1997. Federated is not aware of the financial crisis raising any issues regarding the current treatment of asset-backed securities under Rule 2a-7.

- Are there other credit exposure limits that should be tightened to reduce MMFs' risks?

  - o For example, should certain types of exposures, such as financial-sector exposures, be subject to limitations? If so, what should the limits be? How should such exposures be defined?

This question reflects a lack of understanding of the operation of the Investment Company Act of 1940. The Act requires investment companies (including MMFs) to adopt fundamental policies regarding concentration in industry sectors. Investment companies must choose either to concentrate or not to concentrate in one or more sectors. The SEC does not otherwise have authority to prevent concentration.

SEC regulations currently exempt MMFs from this requirement with respect to bank instruments. In other words, MMFs are permitted to concentrate in bank instruments without committing to always remain concentrated in the banking sector. This reflects the prevalence of banks in the money markets. Of course, the SEC could amend its rules to withdraw this exemption, but this could force prime MMFs to adopt policies of concentrating their portfolios in the banking sector, even if safer investments were available from other types of issuers. Forcing such concentration would increase systemic risk. Prohibiting concentration would force MMFs into other sectors that the Council persists in labeling "shadow banks," which seems inconsistent with the Council's overall policy.

- Should limits on second-tier securities be tightened? If so, how?

No. The SEC adopted the current limits in its 2010 reforms. There is no evidence that the current requirements pose undue risks.

- Should collateral requirements be more stringent? How should that be accomplished?

In brief, Rule 2a-7 requires that an MMF's investment in a repurchase agreement be "*collateralized fully," so that the fund perfects a security interest in collateral that consists entirely of cash items or government securities. This standard should not be changed, as government securities and cash are well suited to serve as collateral in all types of financial transactions. Stricter collateral requirements would reduce the amount of available financing through repurchase agreements, and make such financing more expensive. As a further risk-limiting step, Federated limits its MMFs' exposure on secured transactions (including repo) measured both in respect of the counterparty on the transaction and in respect of the issuer of the collateral. Where the collateral is not U.S. government securities, Federated focuses on the creditworthiness of the counterparty for 2a-7 eligibility and requires additional collateral coverage.*

- Should diversification requirements for providers of demand features and guarantees be tightened? How and to what extent?
    - How might more stringent diversification requirements for providers of demand features and guarantees affect securities markets (particularly markets for tax-exempt securities) in which demand features and guarantees are important?

No. The 2010 amendments to Rule 2a-7's diversification requirements are sufficient. As we have noted above, the 2010 amendments to Rule 2a-7 appropriately limited an MMF's potential exposure to any particular demand feature provider or guarantor by putting in place *stricter requirements regarding second tier securities.*

- Should limitations on other credit or liquidity enhancements be tightened?

No. MMFs are already subject to stringent credit and liquidity standards under the SEC's 2010 amendments to Rule 2a-7.

Increased Minimum Liquidity.

The Release also discusses increasing minimum levels of daily and weekly liquid assets, such as by raising the required level of daily liquidity from the current level of 10 percent to 20 percent, and the minimum weekly liquidity requirement from the current level of 30 percent to 40 percent (tax-exempt funds would remain exempt from the daily liquidity requirement). It notes that these would be significant increases over current requirements, but are below the levels many funds have maintained since 2010. The Council solicits general comment on increased liquidity requirements, and asks the following particular questions:

- Would enhanced liquidity requirements mitigate the impact of increased redemptions on a fund?
    - Are the proposed minimum liquidity requirements sufficient for funds to meet redemption requests during times of stress?
    - Would higher or lower requirements be more appropriate?
    - Rather than increasing both the daily and weekly liquid asset requirements, are there greater benefits or costs associated with increasing one or the other?
    - Should tax-exempt funds continue to be exempt from any daily liquidity requirement?

Liquidity requirements adopted as part of the SEC's 2010 reforms have already resulted in significant benefits for financial stability. As discussed in detail in Arnold & Porter's January 25, 2013 comment letter on the floating NAV, the enhanced liquidity now held by MMFs allowed them to meet heavy redemption demands during the stressful period of the summer of 2011 without incident. In addition, along with new liquidity standards, the SEC has imposed stricter credit quality, diversification, portfolio maturity and disclosure requirements on MMFs. As a result, investors are better able to monitor fund portfolios, MMFs are able to redeem more shares without resorting to forced asset sales, and the likelihood of an MMF breaking the buck has been reduced substantially.

Since the most liquid investments carry lower yields, imposing further requirements in this area will necessarily further reduce investors' returns. While many MMF users are short-term investors, by no means are they all the same. Many MMF users seek to place cash with a MMF manager for periods in excess of weeks or months. During this time, they expect a reasonable return. If regulators couple a capital standard with further, yield-reducing liquidity *requirements, this will further reduce demand for MMFs, and the benefits that MMFs provide to the markets will disappear. Thus, within the present constraints of Rule 2a-7, fund advisers should be able to manage investments and cash as they determine appropriate for their customer base.*

Finally, tax-exempt funds should remain exempt from daily liquidity requirements. These funds have had a very stable history, due to the high credit quality of their holdings and their adherence to the risk-mitigating provisions of Rule 2a-7. New regulations for these funds have not been shown to be necessary, and may result in decreased funding for the state and local agencies whose securities they purchase. MMFs are a critical funding source for state and local governments, and reduced demand for MMFs would increase debt issuance costs for these entities.

- What harmful impacts would higher liquidity requirements have?
  - How might they impact the funding markets in which MMFs participate?
  - Would these requirements result in the institutions that borrow from MMFs shifting to shorter-term borrowing, increasing the risk that they may be unable to refinance their outstanding debt when necessary? If so, how might this impact financial stability?
  - How would this impact the ability of borrowers to address new liquidity and stable funding requirements contemplated in Basel III?

As demonstrated by the events of the summer of 2011, further liquidity requirements are not necessary, because MMFs are already sufficiently liquid to meet high volumes of redemption requests during stressful periods. Pairing further liquidity requirements with a capital requirement will thus unnecessarily reduce MMF investors' returns. Without the ability offer a competitive return, MMFs will not be able to attract investor dollars. This will reduce the amount of funding available in the short-term credit markets, reduce competition in those markets, and increase the cost of capital for businesses. Markets would also become more reactive to near-term events, as the Council's questions anticipate, resulting in greater volatility and gaps in time when institutions are not able to secure short-term financing. All of these results are inconsistent with the goals of Basel III and of the Council.

- Should liquidity requirements be enhanced by revising the current definitions "weekly" and "daily" liquid assets by excluding all non-government securities and repo backed by non-government securities? If so, should this be in place of, or in addition to, higher minimum liquidity requirements?
  - Would this approach reduce the risk of credit or liquidity strains in the securities counted towards these buffers?
  - Would it alleviate the concern of potential unintended consequences such as pushing financial institutions into shorter duration borrowing?

The purpose of liquidity requirements is to assure that MMFs can absorb extraordinary levels of redemptions without being forced to sell portfolio securities. Treasury and short-term agency discount notes are an exception based on the flight to quality that might be expected when MMFs are under stress. The assumption is that MMFs will be able to sell these securities at or above their amortized cost. There is, if any difference, a higher likelihood that a high quality instrument will return its amortized cost at maturity. Thus, any security held by a MMF that matures in one to seven days is at least as reliable a source of funding for redemptions as the sale of longer-term Treasury or agency discount notes. Excluding non-government securities from the definition of daily and weekly liquid assets will not further the purpose of the liquidity requirements.

The secondary questions suggest that the inquiry is prompted by concerns for borrowers, rather than MMFs or their shareholders. While we do not agree with the Council's concern, if the Council feels that borrowers are overly reliant on short-term funding, then it should regulate borrowers directly. Manipulating the definition of daily and weekly liquid assets is more likely to change the form and source of short-term borrowing than the amount, and to cause more problems than it solves.

For example, imposing this type of change would merely turn prime MMFs into a variation on government MMFs. It would, of course, reduce the availability of credit for companies, restrict their growth, and drive down MMF yields, resulting in the negative consequences described above.

- How might increased minimum liquidity levels complement the NAV buffer?
    - Would they reduce the risks present in MMFs' investment portfolios?
    - Would they reduce the probability that an MMF investor would redeem its shares based upon concerns about the MMF's portfolio liquidity?

The level of a fund's liquidity is a concept distinct from a NAV "buffer." As explained in Arnold & Porter's January 25, 2013 comment letters, liquidity allows a fund to absorb investors' demands for redemption of shares. Therefore, it promotes investor confidence. However, a NAV buffer would promote investor confusion by causing some investors to believe that their shares are somehow guaranteed, and by incentivizing investors to look to the status of the buffer, rather than to their own shares, when deciding whether to purchase or redeem. Thus, increased minimum liquidity levels and a NAV buffer would not complement each other, but would work at cross-purposes.

Enhanced Investor Transparency.

The Release notes that additional "know-your-investor" requirements could improve MMFs' ability to understand their shareholder base and to anticipate investors' redemption activity, especially in the context of MMFs held through omnibus accounts. The Council raises the following questions:

- Should MMFs be required to gather more information about their beneficial owners?
    - MMFs could be required to perform certain risk management procedures and consider information about beneficial owners' historical redemption behavior when stress testing their funds. To what extent can MMFs currently increase investor transparency?
    - If regulatory changes are needed to facilitate this level of transparency, how could it be done most effectively by the SEC under its current statutory authority?
- Should MMFs be prohibited from having too concentrated an investor base, or should additional limitations apply if a fund has a concentrated investor base?
    - For example, should an MMF investor be limited to owning no more than a specified percentage of any particular MMF? What limit would be appropriate?

Investors and sponsors may both benefit from additional "Know Your Investor" requirements (which would permit funds to obtain information from sources such as omnibus accounts, portals, and sweep arrangements), if those requirements are properly structured. This additional information would allow funds to better anticipate shareholder redemptions. As discussed in the ICI's letter of January 24, 2013, however, under current rules, MMFs cannot independently obtain this information unless voluntarily supplied by users. Instead, intermediaries should be required to furnish identifying information upon an MMF's request. Until MMFs have the opportunity to analyze the resulting data about their beneficial owners and to provide it to the SEC, the Council should not recommend that the SEC limit the concentration of MMFs' investor base.

More Robust Disclosure.

The Council notes that a NAV buffer could also be accompanied by enhanced disclosure requirements. It suggests that the level or frequency of required disclosures could be enhanced, such as through more frequent (e.g., daily or weekly) public reporting of daily and weekly liquidity levels and mark-to-market per share valuations, or by reducing or eliminating the current delays before public disclosure. The Council suggests these disclosures could be supplemented with disclosures of MMFs' valuation methodologies and the factors they consider when assessing credit risk. MMFs could also be required to disclose instances of sponsor support. Here, the Council raises the following questions:

- Would enhanced disclosure make investors quicker to redeem when indicators show signs of deterioration? Could it increase the volatility of MMFs' flows, even when they are not under stress?
- Would more frequent portfolio disclosure limit MMFs' ability to utilize differentiated

investment strategies?

- Would more frequent reporting of portfolio holdings, mark-to-market NAVs, and liquidity levels help investors and others differentiate among MMFs? If so, what would be the appropriate frequency (e.g., daily or weekly)?
    - How might investors respond to daily changes in an MMF's mark-to-market NAV or liquidity levels?
    - Should MMFs be required to disclose the mark-to-market value of their investments?
    - Would enhanced disclosure decrease or increase the probability of indiscriminate runs across MMFs?
    - Would MMFs be adversely affected by the need to provide enhanced disclosure of their portfolio holdings?
    - Would enhanced transparency have unintended consequences?
- Should MMFs be required to notify investors and the public each time they receive support from their sponsors (including purchases of distressed securities under rule 17a-9 if that rule is not rescinded)?
    - What other kinds of support warrant disclosure?
    - Would this kind of disclosure help investors and others better understand and appreciate the risks in particular MMFs?
    - How should this disclosure be made (e.g., via website or prospectus)?
    - Should MMFs be required to disclose their performance absent sponsor support?
    - Where SEC relief is required for sponsor support, should the SEC no longer entertain requests for the relief?
    - Should the SEC otherwise prohibit sponsor support?
- Should MMFs be required to provide increased disclosure on their valuation methodologies?
    - Should MMFs be required to provide greater information about the factors they take into account, or the processes they follow, when assessing a security's credit risk?
- How might more robust disclosure requirements complement the NAV buffer? Would they reduce the risks present in MMFs' investment portfolios or improve investors'

ability to differentiate between funds?

In light of the extensive information currently disclosed by MMFs and the absence of investors calls for access to additional information, further disclosure by MMFs may not be necessary at this time. The 2010 amendments to Rule 2a-7 greatly increased the transparency of MMFs, making them among the most transparent financial products available today. The assets held by MMFs are more liquid and easier to value than assets held by banks and other financial institutions, including other mutual funds, and Rule 2a-7's requirements allow shareholders to effectively monitor each fund's portfolio holdings and respond accordingly. In addition, many fund sponsors, including Federated, are now taking the additional voluntary step of making daily shadow price information available to users. Regulators should weigh the costs of additional disclosures against the benefits in light of MMFs' current transparency and investor needs. In Federated's experience, investors do not ask for daily shadow price information (with rare exceptions for diligence when an institution is switching to Federated from another fund complex). Additional disclosures may have unintended consequences that should also be weighed. Regulators will now have the opportunity to study the impact of existing disclosures on the behavior of MMF users and the market as a whole, whether investors are making use of the information or requesting additional information, and consider the potential costs and unintended consequences of additional disclosures. Until such analysis is complete the Council should not propose and the SEC should not adopt changes to the disclosure or sponsor support requirements applicable to MMFs.

V. Requests For Comment On Other Reforms.

The Release states that other alternative reforms might also mitigate risks to financial stability and reduce the susceptibility of MMFs to runs. Thus, it solicits comment on other reforms and how they "would address the structural vulnerabilities inherent in MMFs and mitigate the risk of runs and the threat they pose to financial stability." However, the only alternative reforms that the Council specifically describes are liquidity fees and temporary restrictions on redemptions.

The Release states that some have suggested that during times of market stress, MMFs might charge liquidity fees to redeeming shareholders in order to compensate MMFs and remaining investors for the cost of that liquidity, or temporary restrictions on redemptions ("gates") that would prohibit investors from redeeming for a period of time during which the fund could restore its health. The Release states further that these measures may have drawbacks. For example, it states that standby liquidity fees and temporary gates may increase the risk of preemptive runs by investors who may seek to redeem before a fee or gate is triggered, and that the triggering of fees or gates in one MMF could encourage redemptions in others. It states that the Council believes that these proposals alone would not provide explicit loss-absorption capacity or alter the activities and practices of MMFs that it believes pose a threat to financial stability.

The Council solicits general comments regarding the imposition of liquidity fees and "gates." The Council also asks the following specific questions regarding these measures:

- Would investors' concerns about the potential triggering of a standby liquidity fee or gate increase the likelihood of preemptive runs?
    - Would one fund imposing fees or gates lead to runs at other funds?
    - Would a fee serve as a sufficient deterrent to investor redemptions such that MMFs' liquidity buffers could absorb redemptions in times of stress?
- Should the trigger be based on a fund's NAV, levels of daily and weekly liquid assets, or both? At what levels and why? Are there other triggers that would be more effective?
- What would be the appropriate size of a standby liquidity fee?
    - Should the fee's size be based on the magnitude of losses or liquidity costs, or should it be a fixed percentage of the investor's redemption?
    - How would these measures affect the composition of MMF portfolios and risk-taking?
    - Would a flat fee based on the size of the investor's redemptions fairly allocate liquidity costs?

- Should standby liquidity fees or gates be applied automatically based on pre-determined thresholds or at the discretion of the MMF's board of directors (or its independent directors)?
    - Would a fund's board fail to impose a fee or gate even when it would benefit the fund and its shareholders?
    - How could such discretion be structured to make it more likely that it would be imposed when appropriate?
- Would a gate be more effective combined with a liquidity fee? If so, how should the combination be structured?
    - For example, should a fund impose a liquidity fee first, allowing investors to continue to redeem, but impose a gate if the fund is unable to sufficiently recover and reaches a higher level of stress?
    - How would investors view gates?
- Should there be exemptions to a fee or a gate based on the type of fund or investor? For example, should retail accounts or funds be exempt? If so, should such an exemption be based on account size?
    - How could such exemptions work with omnibus accounts?
    - Should there be exemptions for very small withdrawals? If so, what size?
    - Should there be exemptions for Treasury or government MMFs?
- How would a standby liquidity fee or gate would alter investors' view of MMFs?
    - How might it impact the size of the MMF industry?
    - How would the impact be different if the fee were mandatory or discretionary?

The Council should be careful not to conflate the impact of liquidity fees with that of temporary restrictions on redemptions (or "gates"). A liquidity fee would penalize redeeming shareholders by imposing a charge to compensate the MMF for the potential cost of shareholder's withdrawal from the MMF during a stress period. As discussed in Federated's letter of February 12, 2013 submitted to the Council by Steven Keen, a voluntary gate, on the other hand, is a mechanism imposed by an MMF's board when the board deems it prudent in a period of stress, and would prohibit a shareholder from redeeming ahead of others during that period. In stress periods, an MMF with a voluntary gate would be far better equipped to survive large scale shareholder redemptions than an MMF with a liquidity fee. For example, when a credit event occurs, the imposition of a voluntary gate will allow an MMF's board to halt outflows, thus preventing a run while the board considers options for the protection of *shareholders. The voluntary gate would provide an MMF the necessary time to reestablish liquidity as short-term portfolio instruments reach maturity.*

VI. Questions Regarding the Council's Economic Analysis of the Proposed Recommendations.

The Council's Release acknowledges that under Section 120 of the Dodd-Frank Act, it must "take costs to long-term economic growth into account" when recommending new or heightened standards and safeguards for a financial activity. Although the Council notes that "the proposed recommendations … could lead to an increase in the cost of lending that MMFs provide, which could reduce economic growth in normal periods," it also states that "even assumptions that would tend to overstate these potential costs suggest a very small increase in the weighted-average cost of credit for U.S. businesses, households, and state and local governments, with commensurately small potential costs to long-term economic growth."

The Council's economic analysis is based on certain fundamental assumptions. First, it focuses on the 3 percent NAV buffer because, in the Council's opinion, it is the proposed recommendation that would have the most direct and largest effect on lending costs. The Council did not prepare separate analyses of Alternatives One (floating NAV) and Two (lower NAV buffer plus MBR). The Council acknowledges that the MBR in Alternative Two would reduce the liquidity of MMFs for large investors, but states that the associated costs of such a reduction "are not likely to exceed those associated with financing a larger NAV buffer." The Council also states a floating NAV "likely would have a smaller direct impact on borrowing costs and hence smaller costs to long-term economic growth than the other alternatives."

Second, the Council's economic analysis assumes that borrowers will *not* shift borrowing away from MMFs and, as a result, borrowers will fully absorb any higher costs. It further assumes that if other sources of credit are found, borrowing costs are likely to be even smaller, and not larger.

In any event, the Council states that it believes MMFs would fully pass on the additional cost of a 3 percent NAV buffer to borrowers, and that the rate at which MMFs would lend would increase by 0.05 percentage points for each percentage point of short-term claims replaced by subordinated, longer-term claims. While it admits that the increased lending rate would impact economic growth, the Council states that the total credit that MMFs supply is relatively small compared to aggregate nonfederal, nonfinancial debt outstanding. Based on these assumptions, the Council concludes that the weighted-average cost of credit for businesses, households, and state and local governments would increase by only 0.0075 percentage points.

The Council asks the following specific questions regarding its economic analysis of the proposed recommendations.

- How can the assumptions used to estimate costs to long-term economic growth be further refined?

The Council has been provided with survey information regarding investors' willingness to invest in MMFs with the type of floating NAV, MBR, and capital requirements under consideration. For example, in three letters dated January 17, 2013, Treasury Strategies provided data from a survey of corporate treasurers. According to the survey, 79% of corporate *treasurers would decrease or discontinue use of an MMF with a floating NAV; 90% would decrease or discontinue use of an MMF with an MBR-like requirement; and, as stated in the ICI's letter of April 19, 2012 to the SEC, 36% of corporate treasurers would decrease or discontinue use of an MMF with a capital buffer.*

As discussed in detail in Federated's comment letter dated January 30, 2013, the Council needs to revise completely its consideration of the long-term economic costs of the proposed recommendations. First, the Council must assess long-term cost using standard, peer-reviewed methodologies that include all relevant factors. Second, it must use historical data, or at least realistic assumptions, in applying these methodologies. Third, it may not assume that adoption of any proposed recommendation will eliminate, by itself, any risk of a future financial crisis. The Investment Company Institute's letter dated January 24, 2013 also contains a serious critique of the modeling techniques employed by the Council.

- For each of the alternative reform proposals, what do you estimate would be the effect on the total AUM in MMFs?
    - For each of your estimates, what are your underlying assumptions?
    - Given these estimates, what would be the effect on long-term economic growth of such change in the total AUM of MMFs?

As discussed in Federated's comment letter dated January 30, 2013, Section 120 requires the Council *to determine the expected long-term economic costs of its recommendations. There is no reason to believe that Congress intended for the Council to delegate this responsibility to the public. The Council should have included in its request for public comment its estimate of the potential impact of the Proposed Recommendations on the size of the MMF industry, the alternative investments available to their shareholders, the factors influencing long-term economic growth, and whether reforms would reduce the probability or severity of a financial crisis, and the underlying assumptions.*

As detailed elsewhere in these comments, the conclusion that the Proposed Recommendations will significantly reduce the AUM of MMFs is unavoidable. Shareholder comments, testimony and surveys are uniform in concluding that the vast majority of current users will not use, or will significantly reduce the use of, a floating NAV fund for cash investments. The Council has cited no evidence to the contrary, and has not made any concrete proposals to address the tax, accounting, and operational problems a floating NAV would entail.

Shareholders have been equally clear in their unwillingness to accept an MBR, which would be too complicated for most shareholders to fully understand. The Council has also failed to acknowledge or address the staggering costs and operational changes an MBR would entail, which would deter most intermediaries from offering MMFs to their customers.

Finally, the Council has failed to accept the fact that, with prime MMFs currently yielding 5 basis points or less and MMF managers waiving a significant portion of their fees, there is no money with which to pay for or build the proposed capital cushion. If the Council *imposes a capital requirement that prime MMFs cannot possibly meet, then the obvious consequence is that prime MMFs will no longer be offered.*

- Which features, if any, of the alternatives would potentially make MMFs less attractive to investors?
    - If MMFs became less attractive to potential shareholders, where would they invest their funds?
    - Would institutional customers or retail investors be more likely to withdraw funds?
    - What alternative cash-management vehicles would investors likely move to?
    - Would this affect the expected benefits of MMF reform?
    - What impact would this have upon the credit markets in which MMFs invest?
    - How should the role of other financial intermediaries be considered?
    - What risks could that pose for financial stability?

The multitude of comment letters submitted to the SEC and summarized in Arnold & Porter's letters dated July 17, 2012 and January 25, 2013 discuss these issues in great detail. Almost every letter submitted describes the essential role MMFs play across a range of cash management operations for individual users, businesses and public entities, as well as the essential role of MMFs as purchasers of corporate commercial paper and state and local government debt. Commenters are consistent in explaining that they will not use, and in some cases cannot use, MMFs if any of these three proposals are adopted. If that occurs, a shrunken MMF industry would result in increased cost of funding for businesses and governments and would be enormously costly for the economy. Investors would be forced into less-regulated, less-transparent vehicles or into the largest banks, either way increasing systemic risk. State Street's letter of January 25, 2013 points out that neither of these options presents a suitable alternative to MMFs, particularly in light of the inability of banks to profitably accept these additional deposits or to replace MMFs as substantial purchasers of short-term securities. As a result, these proposals would have precisely the opposite effect that rule proponents desire.

- If MMFs became less attractive to potential borrowers, how might they change their financing methods?
    - Would this affect the expected costs or benefits of MMF reform for long-term economic growth?

As assets flow out of MMFs and into less-regulated and less-transparent products or to banks as a result of the Council's recommendations, borrowing costs will increase. As discussed in Federated's letter of January 30, 2013, borrowing rates for prime issuers could in fact rise by 100 basis points or more, depending upon the sector, credit, and size of issuer. This sharply *higher borrowing cost, added to the potential drop in savings resulting from lower returns to MMF shareholders (who will invest in Treasury funds) could have a much more adverse effect on savings and investment than the Release forecasts.*

- Would yields on redeemable MMF shares decline, in light of reductions in risk?
  - Would there be additional costs to long-term economic growth from reduced yields to MMF shareholders? If yes, what would they be?

Yes. As discussed in Federated's letter dated January 30, 2013, the reduction in MMF yields that will result from the recommendations would discourage capital formation.

- Would a reduction in profits for MMFs sponsors absorb some of the increase in costs?
  - How would their reduced profits affect long-term economic growth?

The large-scale outflow of assets from MMFs that would result from the Council's recommendations would no doubt reduce the profits of MMF sponsors, although this would do nothing to absorb the increase in costs. Many sponsors would simply exit the market, reducing investor choice and increasing the flow of assets to less-regulated and less-transparent investment vehicles as well as the largest banks.

- Are there factors other than borrowing costs, reduced yields to shareholders, and reduced profits for MMF sponsors that may be expected to impact long-term economic growth?

Federated's letter dated January 30, 2013 discusses in detail the analysis the Council should undertake in terms of macro-economic growth theory, financial theory, costs to efficiency, the potential impact on innovation, diversity, and competition among financial institutions, the potential effect on economic welfare, and the assessment of systemic risk.

- Would higher short-term borrowing rates from MMFs affect other short-term borrowing rates?
  - Are BBB corporate rates and the equity risk premium appropriate proxies for the returns likely to be demanded by providers of the NAV buffer?
  - How should reductions in the structural vulnerability of MMFs impact the potential probability of a financial crisis? The severity of such a crisis?
  - What additional benefits to long-term economic growth might result from reductions in the structural vulnerability of MMFs?

As explained in Federated's January 30, 2013 comment letter, the form of perpetual capital, subordinated to common equity, proposed in Alternatives Two and Three would be unprecedented. It would require a rate of return higher than the average equity risk premium.

The Council's Release provides no support for the proposition that the "structural vulnerabilities" of MMFs impact the probability or severity of a financial crisis. Moreover, the Council concedes in its Release that neither a floating NAV, nor an MBR requirement, nor a capital requirement will prevent runs in a crisis. The benefits it suggests are entirely unproven and speculative.

Moreover, determining the expected long-term economic costs of proposed recommendations under Section 120 is the obligation of the Council. Section 120 does not allow the Council to shift this burden to the public, and the Council should not have proposed recommendations without first performing a serious analysis of their potential impact on the size of the MMF industry, the alternative investments available to their shareholders, the factors influencing long-term economic growth, and whether the recommendations would reduce the probability or severity of a financial crisis. When as much as $2 trillion may flow out of MMFs under the weight of the Council's proposals, the Council cannot ignore its statutory obligation to consider the damage.