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May 19, 2011

VIA E-MAIL RULE-COMMENTS @SEC.GOV

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

Re: File No. 4-619—President's Working Group Report on Money Market Funds

Dear Ms. Murphy:

Federated Investors, Inc. ("Federated") would like to thank the Securities and Exchange Commission (the "SEC") for allowing John Hawke to present our views on money market fund reform to the SEC Roundtable on Money Market Funds and Systemic Risk (the "Roundtable"). We would also like to take this opportunity to (1) address squarely the public policy concerns raised by various regulators during the Roundtable, (2) respond to some of the agenda items that the Roundtable did not have time to address, and (3) substantiate certain claims made during the Roundtable.

I. PUBLIC POLICY CONSIDERATIONS

The central policy question is whether tax dollars should be used to prevent a run on money market funds. There was really no disagreement on this point—the answer is no and the real question is how best to prevent this from happening. We hope that the SEC noted that none of the representatives of money market fund investors, managers or industry associations assumed that any form of federal guarantee would ever be provided to money markets. Only the current and former representatives of regulatory agencies alluded to an "implicit government guarantee" of the funds' stable net asset values ("NAVs"). Given that there is no such government guarantee (implicit or explicit) and that the authority for the temporary guarantee provided to shareholders in 2008 was rescinded by the Dodd-Frank Act, there is no basis for these assertions. Statements by public officials that presume some form of government guarantee for money market funds can only foster expectations of support, which is contrary to our shared policy objective.

Given that we all seek to avoid any need for a government guarantee of money market funds, there is no reason to suppose that money market funds create any moral hazards for the financial system. We have already explained how the temporary guarantee program did not create any moral hazard on the part of managers or shareholders.[1] The Roundtable participants representing investors confirmed that they do not view funds as guaranteed by the government and do not encourage funds to take undue risks to generate yield. No one who claims a moral

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[1] See our comment letter of March 25, 2011, available at http://www.sec.gov/comments/4-619/4619-83.pdf.

hazard has provided evidence to substantiate the claim, or even provided a plausible explanation of how the hazard might have been created.

A wholesale run on money market funds need not present a systemic risk to the broader financial markets or the U.S. economy so long as borrowers can obtain alternative short-term funding from other sources. Many money market instruments are already structured to include an alternative funding source, such as stand-by liquidity facilities for commercial paper and municipal demand obligations. Other instruments have collateral that can be used to secure alternative funding. Establishing a liquidity facility bank will provide an additional funding source during periods of financial crisis. The liquidity facility bank will help to shield the rest of the credit market from the effects of a large scale run on the funds, and will do so at the expense of the funds and their managers—not the taxpayer.

Most of the other reforms discussed at the Roundtable seek to avoid a run on the funds. Some reforms, such as floating the NAV, have already proven to be ineffective in preventing runs. Other reforms, such as capital requirements, cannot provide sufficient protection on a cost-effective basis to prevent a run. More fundamentally, raising investor expectations of safety is antithetical to the objective of avoiding a government guarantee. If investors who regard money market funds as "riskless" are part of the problem, reducing the perceived risk of the funds cannot be part of the solution.

Federated also thinks that the policy questions regarding the liquidity facility bank were exaggerated. Although a central bank is only required to provide liquidity to the banking system, the "social contract" requires banks to use that liquidity for the benefit of the financial system, including providing liquidity to the market. Money market funds would not consider a special purpose bank if they could rely on other banks to provide liquidity in times of stress. A severe financial crisis is apt to affect banks first, however, and to a greater extent than other sectors of the financial markets. Indeed, if the Dodd-Frank Act reforms work as intended, during the next financial crisis money market funds can expect one or more major financial institutions to undergo a rapid "resolution," with a corresponding reduction in market liquidity.

A liquidity facility bank will provide an assured source of liquidity to money market funds. Limiting the liquidity facility bank's activities and investments will shield it from events that might impair the capital of other banks or require other banks to restrict lending activities. It would also avoid the possibility that a bank that has committed to provide funding for redemptions may fail before a money market fund can draw on the commitment.

Federated does not agree that the creation of a liquidity facility bank raises any far-reaching policy implications for the Fed. As Mr. Hawke noted at the Roundtable, the liquidity facility bank would be subject to regulatory oversight by the Fed and would use the discount window on the same basis as other banks. The demand for loans at the discount window is always a consequence of the lending and other business activities of the banks requesting the funds. The Fed has never viewed this as a justification for regulating the panoply of companies that rely on these banks to finance and conduct their businesses. A liquidity facility bank would be uniquely transparent: funds obtained at the discount window could be traced to specific transactions, rather than disappearing into a welter of activities. We do not see why this transparency would justify Fed regulation of money market funds, insofar as the Fed has never asserted jurisdiction over any other ultimate beneficiary of borrowings at the discount window.

II. POTENTIAL FOR MONEY MARKET FUNDS TO POSE A SYSTEMIC RISK TO BROADER FINANCIAL MARKETS

A. What makes money market funds vulnerable to runs?

We think this question was plainly answered by the Roundtable: investors do not redeem in order to dilute their fellow shareholders by being the "first mover." This motivation affects shareholders in stable and floating NAV funds alike. We thought Mr. Baker's comments most telling on this point: the financial crisis also triggered a run on floating NAV funds in Europe that required government intervention. According to information provided by Strategic Insight, when measured as a percentage of net assets, total net redemptions from floating NAV money market funds in Europe in September and October 2008 were only 1% less than total net redemptions from stable NAV money market funds during the same period.

Short-term floating NAV funds in the U.S. suffered similar runs. One ultra-short fund suffered such heavy redemptions during a one-week period that it was forced to liquidate with support from its adviser; another fund's net assets fell from $13.5 billion to $1.8 billion in an eight-month period; and a limited duration fund was forced to sell 50% of its assets over a one-week period to cover expected redemptions.[2] The ICI estimates that ultra-short funds lost almost 60% of their assets in 2008 - much of this before the crisis in September 2008.

Finally, the investor representatives at the Roundtable stated that a stable NAV does not lead them to view money market funds as "riskless." The steps taken by money market funds to limit the deviation between their shadow prices and their stable NAVs foster a genuine expectation of safety on behalf of their shareholders. The execution of trillions of transactions at $1 per share for more than forty years belies any characterization of a stable NAV as "fictional." Nevertheless, shareholders understand that a fund cannot maintain a stable NAV in all circumstances, and are willing to accept this risk in exchange for diversification and a reasonable rate of return.

B. How should the role of money market funds in the short-term funding market be viewed through the prism of systemic risk analysis?

First, as was noted at the Roundtable, a run on an individual fund or even a fund complex does not present a systemic risk to the broader financial market. So long as investors are withdrawing from a fund that broke a dollar, rather than from the general short-term credit market, other market participants should be able to provide the needed liquidity. Federated's acquisition of assets from a Putnam fund, at the height of the financial crisis in September 2008, illustrates how an individual fund can be resolved without causing any serious disruption to the financial system.

Second, this implies that a general run on money market funds will probably be one aspect of a broader financial crisis, as was the case in September 2008. Mr. Volcker's assertion that money market funds are a systemic risk because they could not withstand the crisis without federal support ignores the fact that every type of major financial institution required support

[2] In the Matter of Evergreen Investment Management Company, LLC and Evergreen Investment Services, Inc., Administrative Proceeding File No. 3-13507 (June 8, 2009); In the Matter of Charles Schwab Investment Management; Charles Schwab & Co., Inc.; and Schwab Investments, Administrative Proceeding File No. 3-14184 (Jan. 11, 2011); In the Matter of State Street Bank and Trust Company, Administrative Proceeding File No. 3-13776 (Feb. 4, 2010).

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during the crisis in September 2008. There is no justification for requiring money market funds to be uniquely immune to systemic risks created by other market participants.

Third, there should be no disputing that money market funds strengthen our credit markets. We believe that the track record of money market fund managers surpasses that of every other financial institution in terms of the quality of their credit analysis. Certainly a smaller percentage of funds had a much smaller exposure to defaulted securities during the financial crisis than banks, investment banks or insurance companies. As the SEC's staff learned during its sweep examination of money market funds, in *February 2007* Federated and many other major mangers reviewed their funds' exposures to subprime mortgages (primarily indirect exposures to issuers engaged in subprime lending activities) and reduced these exposures to the greatest practical extent. The rating agencies did not start to place subprime securities on credit watch until July 2007, at which point most market participants started to conduct reviews that money market funds had completed months earlier.

Money market funds managers also maintained liquidity in their funds well beyond normal levels going into September 2008. This liquidity allowed all but two fund complexes to meet extraordinary redemption demands for several days while the temporary guarantee was formulated. Although no one could have foreseen the depth of the crisis that followed Lehman's bankruptcy, money market fund managers were better prepared for it than other market participants.

Reducing the assets managed through money market funds, which will be a necessary consequence of a floating NAV, will certainly weaken the credit markets and probably increase systemic risk. As the investor representatives indicated during the Roundtable, they are not equipped to engage in the in-depth credit analysis performed by money market fund managers, and will be forced to concentrate their investments in fewer issuers. It is also reasonable to assume that direct investors will rely more heavily on credit ratings, without the independent analysis required by Rule 2a-7. The increased concentration will increase the systemic importance of large financial institutions and the consequences of errors made by the rating agencies. Finally, over half of the industry's current assets are managed by subsidiaries of bank holding companies already deemed systemically important by the Dodd-Frank Act. Most of these assets will probably be shift to bank deposits, common and collective trust funds and other stable value products, which will increase the systemic risks posed by these institutions.

III. REGULATORY OPTIONS AND THEIR IMPLICATIONS

A. Floating NAV vs. Bank regulation

1. *What are your expectations of investor behavior and market responses to a floating NAV?*

The response of the investor representatives at the Roundtable was unambiguous—they will not use floating NAV funds for cash management. The comments letters from investors are equally clear. Although they are willing to accept a one-time loss due to a significant credit or market event, they see no reason to incur regular losses due to meaningless fluctuations in the fund's shadow price.

2. *The PWG report suggests that the stable NAV tends to "amplify" risks in a money market fund that stem from a mis-match between assets and liabilities. Investors are incentivized to be the "early redeemer" (get out while the fund is still paying $1.00). Losses are concentrated in the remaining shareholders. Why wouldn't moving to a floating NAV dampen the systemic risk?*

First, there is no "mis-match." Money market funds do not have any material liabilities; they have only redeemable equity securities. While their shares are normally redeemable at a stable $1 price, shares may be redeemed at this value only if it would not result in material dilution or other unfair results to shareholders. Thus, the redemption value of a money market fund's shares will change if necessary to avoid any material difference between the value of its assets and its redemption obligations.

This is not solely a legalistic point. Although money market fund shareholders have the right to redeem their shares on any business day, the fact is that each day some shares are redeemed and others are purchased, so that funds experience daily net inflows and outflows. A money market fund "matches" its assets and obligations by maintaining sufficient liquidity to cover its maximum expected net outflows. Federated's portfolio managers have matched assets and obligations in this manner for over forty-years. None of our prime funds has ever had to borrow money to meet daily net redemptions.

The requirement to "match" assets and obligations has been codified in the general liquidity requirement recently added to Rule 2a-7. All money market funds must know their customers, assess the potential demands that customers may place on their funds' liquidity and maintain sufficient liquidity to meet these demands. In addition, every fund must maintain daily and weekly liquid assets sufficient to meet the highest level of redemptions ever experienced by the industry. Thus, the recent amendments to Rule 2a-7 have effectively removed the risk of any meaningful "mis-match" between money market fund assets and liabilities.

Second, a floating NAV will not reduce systemic risk because investors will run whenever they perceive a risk of losses in excess of their risk tolerance. We wish that the Roundtable had spent more time considering Chairman Shapiro's question as to whether managers would race to provide the "highest quality" short-term floating NAV funds, because this illustrates the problem. If "high quality" means extremely low volatility, then the Chairman is probably right—managers would employ all manners of techniques to minimize the fluctuations in their funds' NAVs. Investors would then expect the funds to exhibit very low volatility, and would redeem their shares if the volatility exceeded their expectations. Thus, a portfolio default would have the same affect on these "high quality" funds as it would on money market funds—large scale redemptions by shareholders seeking to avoid unanticipated losses.

3. *It's been suggested that $1.00 stable NAV effectively grants investors a put to the fund, and then (if the fund cannot make good) to the management company, which thereby assumes first loss risk. If so, should the ability of a management company to support the first loss be material to a fund investor?*

We do a disservice to investors by referring to the right to redeem as a put, much less a guarantee. As noted above, a shareholder is entitled to receive $1 per share only if the deviation from the shadow price is de minimis and it will not produce unfair results to the other shareholders. In previous defaults, high recoveries on defaulted securities made the managers' decision to support their funds relatively easy. For example, all of Orange County's and General American's obligations were eventually paid in full, with interest to the date of payment. The most recent crisis is the first time that managers incurred substantially losses due to defaults, and it is not clear that they anticipated such losses at the time they provided support to their funds. We should not assume that managers will incur such losses in the future, and we should never encourage investors to rely on manager support rather than the underlying integrity of the fund's portfolio.

4. *Several comment letters asserted that investors would abandon money market funds if they were required to have a floating NAV. Would investors still want a short-term investment vehicle if its NAV floats?*

Unfortunately, the Roundtable did not have an opportunity to answer this question directly. Given their unqualified demand for a stable NAV product with market rates of return, however, it would be logical to assume that Ms. DeNale and other corporate treasurers would be willing to invest in unregistered stable NAV funds and Ms. Hewett and other municipal treasurers would be willing to invest in a government investment pools if money market funds were no longer available.

5. *How might the short-term funding markets be affected/adjusted?*

As previously noted, professional cash managers exert a positive influence on the short-term credit markets. A floating NAV will reduce the assets they manage because investors want to invest their cash at a stable price. A floating NAV will therefore reduce both the supply of short-term credit and the quality of credit decisions.

6. *Do you believe that any form of a two-tier system for money market funds, in which some funds have a stable NAV and others have a floating NAV, would work? Would money market fund investors appropriately differentiate the risk between the two types of funds?*

We continue to believe that a two-tier system would unfairly penalize institutional investors that do not present any greater liquidity risks than the average retail investor. Consider, for example, an individual who has a substantial investment in a "retail" money market fund. If the individual dies and leaves the money in a trust for the benefit of his heirs, will the SEC require the trust to redeem the account and invest in a floating NAV fund because a trust is an "institutional" investor? Federated believes that individuals have as much right to professional management of cash held in "institutional" arrangements as they do for cash held in their name.

We think the Roundtable and comment letters clearly show that investors will differentiate a two-tier system by using stable NAV funds and not using floating NAV funds. We expect institutional investor to try to find ways of getting into stable NAV funds or, if they cannot, to use unregulated stable NAV products. The inability to net offsetting institutional and retail cash flows will also weaken the stable NAV funds. The proponents of a two-tier system did not address these problems, or how the tiers would be defined and enforced.

7. *Europeans have money market funds with both stable and floating NAVs. How have European investors reacted to a floating NAV in Europe, particularly during times of financial stress?*

Mr. Baker answered this question directly, but we would like to point out that, in our experience, European investors prefer stable NAV funds. We were one of the first managers to offer stable value funds in Europe, and have consistently found that most European investors look for money market funds that are operated within the risk limitations imposed by Rule 2a-7. We have always operated our offshore funds in accordance with Rule 2a-7's general requirements and believe that most major competitors do so as well.

In addition, the Government Accounting Standards Board incorporates the requirements of Rule 2a-7 for government investment pools that seek to maintain a stable NAV. (*See* GASB Statement 31.) All of the 3(c)(7) stable value funds of which Federated is aware also use Rule

2a-7 as the baseline for their policies. In short, Rule 2a-7 is recognized throughout the world as the standard for stable value investment.

The remaining questions in this part of the agenda were either addressed during the Roundtable or are clearly contrary to our views, so we will not address them any further.

B. Hybrid approaches to regulation: Private liquidity bank

We would like to expand upon a point to which Mr. Reid alluded during the Roundtable. All participants in the credit market—borrowers, investors and intermediaries—share an interest in assuring sufficient liquidity to prevent the market from freezing up during a financial crisis. To the extent that money market funds and their managers are willing to invest in a bank that will reduce their reliance on market liquidity at such times, they will be providing a benefit to the entire credit market. Therefore, a special purpose liquidity facility bank represents a subsidy from the money market funds to the overall market. It would not be a subsidy to the funds.

C. Hybrid approaches to regulation: Mandatory reserve/capital requirements

The problem with every proposed form of capital requirement is that it pushes fund farther in the wrong direction. The investor representatives acknowledged that money market funds are not riskless and that investors expect, at most, that a fund's sponsor will absorb a reasonable amount of losses to protect its franchise. Capital requirements would raise investor expectations and give credence to Professor Sirri's view that money market funds are somehow "guaranteed." It seems evident to us that raising investor expectations of safety will only make it harder to avoid government support during financial crisis, as shareholders will justifiably claim that they had been assured by federal regulations that the funds would be guaranteed. The ever increasing demands made on federal deposit insurance during each banking crisis provide ample evidence of this phenomenon.

With respect to the proposed "buffer," our experience during September 2008 was different in that we found few bidders for many classes of portfolio securities. While a buffer (assuming the fund has built one) will help absorb market losses incurred on sales of portfolio securities, the fund must first be able to find buyers for the securities. It may be dangerous to adopt a reform that presumes that every fund will be able to do so

During the Roundtable discussion, Professor Stulz shared an analysis of how money market funds should be able to issue first-loss notes at a cost of only a few basis points. While we understand his analysis in theory, we are skeptical of its validity in practice. First-loss protection is simply a form of insurance. It is a particularly strong form of insurance - there are no exclusions, losses are paid automatically as they are incurred and are not subject to a deductible. The cost of such first loss protection should therefore be higher than the cost of portfolio default insurance, which traditionally has a substantial deductible, exclusions from coverage and a claims process.

The ICI's Money Market Fund Working Group investigated the possibility of obtaining portfolio default insurance on an industry-wide basis. They were told that the funds could not obtain that much insurance (insuring 3% of just the prime funds' assets would require over $50 billion of capacity) at *any* reasonable price. If insurance companies are unwilling to provide default protection for a "few basis points," we doubt that other investors would be willing to provide stronger first-loss protection to an entire industry without charging a more significant premium than Professor Stulz anticipates.

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We were also surprised, in light of concerns regarding over-reliance on short-term funding expressed during the Roundtable, that the SEC would consider creating a new funding risk for money market funds. Requiring money market funds to issue first-loss notes would make them dependant on the noteholders' willingness to continue funding the notes. If a money market fund could not sell the required notes, it would fail and be forced to liquidate. As we noted in our comment letter, all the Squam Lake proposal does is shift the reasons investors will run from portfolio defaults to failures to meet capital requirements, without reducing any systemic risk to the financial markets.

D. Hybrid approaches to regulation: Liquidity fee and other proposals

We hope the SEC appreciates that a liquidity fee is just another version of breaking a dollar: investors would receive less money than they invested. This would deter investors as much as a floating NAV, and probably more, because the loss is certain rather than probable.

We have analyzed various means of isolating distressed securities that are similar to the hold back proposal. We would be happy to discuss our thoughts with the SEC and some of the difficulties we anticipate for this approach. We think this approach would be preferable to a capital requirement if we could develop a reasonable means of implementing it.

Any limitation on percentage ownership would require complete transparency with respect to a fund's beneficial shareholders and an obligation on the part of financial intermediaries to enforce the limitation. If the SEC and other regulators were willing to require this degree of cooperation from broker/dealers, banks, clearing companies and other regulated securities intermediaries, the existing "know your customer" requirements will probably be sufficient to limit the liquidity risk of large shareholders. In any event, the SEC should not adopt a rule that would require shareholders to redeem when the fund is already experiencing net outflows, as this will create a structural run on the fund.

IV. CONCLUSION

We continue to be surprised by the double-standard being applied to money market fund reforms. Banks required more extensive and costly government support than money market funds during the financial crisis of 2008. While extensive regulatory reforms have been proposed for banks, these reforms would not require fundamental structural changes comparable to requiring money market funds to float their NAVs or start to maintain capital. Although banks continue to pose greater systemic risks than money market funds ever could, no one is conducting roundtables to discuss whether banks should be forced to change their essential nature so as to eliminate these risks. We do not understand why federal regulators feel compelled to hold money market funds to higher standards than other financial institutions.

We remain committed to avoiding any recurrence of the financial crisis experienced in September 2008. We are equally committed to the continuation of money market funds as an important sector of the financial markets. We will be happy to continue to work with the SEC on reforms that are consistent with both of these objectives.

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Please feel free to contact us if you have any questions or require additional information relating to our comments.

Yours very truly,

/s/ John W. McGonigle

John W. McGonigle
Vice Chairman

cc: The Honorable Luis A. Aguilar
The Honorable Kathleen L. Casey
The Honorable Troy A. Paredes
The Honorable Mary L. Schapiro
The Honorable Elisse B. Walter

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