

John D. Hawke, Jr.

John.Hawke@aporter.com

+1 202.942.5908

+1 202.942.5999 Fax

555 Twelfth Street, NW  
Washington, DC 20004-1206

February 24, 2012

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

Re: President's Working Group Report on Money Market Fund Reform;  
Release No. IC-29497; File No. 4-619

Dear Ms. Murphy:

We understand that the Commission continues to evaluate additional structural reforms to its regulation of money market mutual funds ("MMFs"), including a capital requirement and a 30-day holdback of a portion of an investor's redemption proceeds. We submit this supplemental comment letter on behalf of our client Federated Investors, Inc. ("Federated"). We believe that such requirements would seriously undermine the utility of MMFs to businesses, governments, investors, and other private and public sector participants in a range of industries. As explained in greater detail below, a holdback requirement (or minimum balance requirement variant of the same) would eliminate the very liquidity of MMFs that has been central to their widespread use in a variety of applications, including corporate payroll processing, storing corporate and institutional operating cash balances, 401(k) and 403(b) employee benefit plan processing, and holding broker-dealer customer cash balances. A capital requirement, which we understand is also being contemplated, would depress already low yields on MMFs, reducing their attractiveness to corporate and retail investors. Finally, we understand that moving MMFs to a floating net asset value is also being considered by the Commission. Please refer to our previous submission dated December 15, 2011 on that subject, which discusses the impact of a floating NAV on a range of business systems.

We strongly caution the Commission to appreciate the far-reaching consequences of these changes before proposing fundamental reforms that would threaten the ability of countless economic participants to use MMFs in conducting basic, everyday business transactions. This dramatic reduction in the size of MMFs would also have a potentially devastating impact on the short-term markets and raise the cost of capital for countless

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# ARNOLD & PORTER LLP

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corporate and municipal issuers. Respectfully, we urge the Commission to refrain from implementing fundamental changes to the regulation of MMFs at this time and to instead conduct a careful analysis of the effectiveness of the 2010 amendments to Rule 2a-7 and recent enhancements to its oversight of MMFs in order to determine whether any further changes to MMF regulation are warranted. We urge the Commission to also consider the serious potential market ramifications that even the proposal of a rule could have, particularly when coupled with improvident statements intended to justify the adoption of the proposal.

Same-day settlement of the entirety of a transaction amount is a crucial feature of MMFs that underpins their widespread use to hold short-term cash balances. Imposition of a holdback requirement—no matter the amount—for any number of days would destroy the ability of companies and individuals to use MMFs as a liquid investment that can be readily redeployed, on a same-day basis, towards other uses. For example, a 30 day holdback of 5% of a desired redemption amount<sup>1</sup> would leave a transaction unsettled for the entirety of the holdback period. Both parties would carry the unsettled transaction as an open position and each party would be exposed for 30 days to the risk that its counterparty would default. Exposure to this degree of counterparty risk is wholly untenable, and any such holdback requirement would completely undermine the high liquidity of MMFs on which investors rely. If MMFs cannot be used to completely settle transactions on a short-term basis, investors will be forced to use other, less efficient alternatives for their short-term cash holdings.

The net result of a holdback requirement would be to make MMFs impractical to hold the large, short-term cash balances used in transaction processing systems across a wide variety of businesses and applications. If MMFs no longer provide a business solution for holding short-term cash balances for each of these various processing functions, something else would need to be used. The vehicles that formerly held these pending balances before MMFs filled this need included credit balances at the commercial counterparty (due-to and due-from amounts at a commercial company, or free credit balances at a broker), bank short-term investment funds, corporate variable amount notes, and bank deposits. These vehicles have fallen out of use for this purpose

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<sup>1</sup> We have used 5% in this comment letter because a report in the Wall Street Journal indicated that a 5% holdback percentage is under consideration by the Commission. Ackerman & Grind, "U.S. Sets Money-Market Plan: SEC Aims to Stabilize \$2.7 Trillion Industry; Industry Critics Say Rules Would Cut Returns," Wall Street Journal, Feb. 7, 2012 at A-1. However, the analysis is similar regardless of the holdback percentage.

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or might no longer be available, and each carries with it much greater and more concentrated default risks.

Examples of some of the transaction processing systems that use MMFs to hold short-term cash balances are set forth below, along with a description of how imposition of a holdback requirement would undermine the usefulness of MMFs in those particular applications. A summary of some of these implications is provided in Appendix A to this letter. As illustrated by these examples, eight common problems would result from the imposition of a holdback requirement:

- (i) Accounting systems, which are automated and connect transfer agents, mutual fund complexes, banks, brokers and commercial users of MMFs, are not designed to account for and track a holdback. A holdback would require costly reprogramming of these systems and manual reconciliation of transactions. A holdback would require ongoing separate tracking of what would be essentially an open trade in a small amount for the period of each separate holdback. This is a different and far more complex accounting problem than applying a redemption fee, which is a single point in time event in which an amount is deducted at that point in time and immediately credited back to the MMF. The capability of some existing accounting systems to apply a redemption fee could not, as a result, be utilized to account for a holdback requirement.
- (ii) A holdback requirement would disrupt finely tuned payment and settlement systems and would decrease cash available to settle all types of transactions. Same-day or next-day processing of securities and other transactions would no longer be possible, thereby increasing transaction fails, delaying settlement cycles, and increasing float and counterparty risk in system.
- (iii) Within omnibus accounts, tracking holdbacks allocated to individual investors would add an additional layer of complexity that accounting and payment systems are not presently equipped to handle. Redesigning established processes and accounting systems to properly track and allocate holdbacks would be costly and labor-intensive.
- (iv) MMFs are used in many different commercial applications to hold short-term cash balances in precise amounts, and companies often do not have 30 days' advance notice of transfer amounts. A strategy to "gross-up" redemption requests by about 5% would only further impair a corporation's liquidity.

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- (v) Total amounts subject to the 5% holdback would be proportional to the gross transaction volume in a 30-day period. Multiple redemption requests could cause large portions of an investor's MMF holdings to be essentially inaccessible to the investor. The operational issues associated with a holdback cannot be cured by changing it into what has been termed a minimum account balance requirement, because such a requirement would necessitate continuous tracking of changing account balances to determine which redemptions might trigger an actual restriction. We are not aware of any accounting systems that are able to track such information nor do we have an estimate of the expense that would be incurred to try to modify existing systems at the transfer agent and intermediary level to meet this requirement.
- (vi) Individual and corporate MMF investors would face challenges in simply knowing the amount of their available cash balances—that is, balances *not* subject to a holdback—as varying amounts intermittently become subject to and are released from the holdback. The increased burdens of accounting for available cash balances, coupled with the inability to access large amounts of short-term liquidity for weeks at a time, are certain to be highly unpopular with the public. During the late 1980s through the 2000s, banks, clearinghouses, and bank regulators faced massive public pressure to substantially shorten bank holds on deposited checks. The public reaction to any regulation that similarly deprives investors of access to their short-term cash is likely to be just as severe.
- (vii) State and local governments, qualified plans, trustees of traditional trusts, corporate and municipal bond trustees, and securitization trusts, would face operational and fiduciary law or municipal law obstacles to the use of MMFs for the management of cash balances, if redemptions become subject to a holdback requirement.
- (viii) Treatment of MMFs as cash equivalents under accounting standards may be compromised by a holdback requirement, redemption fee or other changes to MMF regulation that are being considered.

The following discussion demonstrates that the effects of a holdback requirement would indeed be widespread. We caution the Commission to appreciate the far-reaching repercussions of a holdback requirement before proposing reforms that threaten to destabilize well-established market practices in a wide range of industries.

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## **1. Corporate Payroll Processing**

Most companies pay their employees either twice per month or every two weeks. Generally, pay is disbursed to all employees on the same days. The pay is either distributed in a direct deposit to an account previously designated by the employee, or in a physical paycheck given to the employee. The aggregate amount of money involved in each payroll disbursement is very large. The bigger the company, and the larger its employee base, the larger is the aggregate amount of cash involved. The corporate treasury department manages its cash availability through a variety of short-term investments that are sufficiently liquid to address scheduled payments that must be made. Payroll is a very large and recurrent payment amount.

Pending distribution to employees, the cash must sit somewhere. Large companies commonly use third-party vendors to handle payroll processing, but employers are not eager to incur the credit risk of such vendors on payroll balances, even for a short period of time. For a given pay period, the aggregate payroll amount for a large company is many millions of dollars, well in excess of the standard \$250,000 FDIC deposit insurance limits (which limits are only temporarily suspended on noninterest bearing demand deposits until year-end 2012). If the entire balance is placed on deposit at a bank, and the bank fails, the company is at risk of losing a large portion of the payroll balance in excess of \$250,000. Companies with large payrolls are understandably anxious about limiting their loss exposure in the event of the insolvency of a bank. From the bank's perspective, many banks are not eager to take on multi-million dollar deposit balances for periods of a few days each month, because there are costs involved with having those balances on the bank's balance sheet and the bank is not able to profitably invest the cash for such a short period of time.

As an alternative, many large employers place cash pending distribution of payroll into MMFs, with an automated sweep into the payment system and vendor used by the employer. An MMF knows in advance, through communications with the employer and experience, how much money is coming in and out and when it will arrive and depart, and is able to profitably invest the proceeds through the MMF's portfolio for a few days in short-term instruments, carefully managing the cash position of the MMF with advance knowledge of the amounts and schedules of the payroll arrival and disbursement.

A key feature that allows MMFs to work to hold short-term balances for corporate payrolls pending distribution is the same-day processing of investments and redemptions of shares. The bank that is processing the payroll distributions makes payments as

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checks and other items are presented through the banking system, and is able to redeem shares of the MMF and receive payment on a same-day basis and avoid an overnight overdraft.

If MMFs were required to hold back a portion of a redemption for 30 days, an employer would have to place a redemption request 30 days in advance of a payroll disbursement date in order to ensure enough funds would be available to make the payments. However, due to fluctuations in staffing and the unpredictability of actual accruals of hourly work performed in a given pay period for hourly employees, businesses cannot know 30 days in advance what the total payroll expense in a given pay period will be. Even if a company's payroll expenses were stable and predictable, issuing a redemption request 30 days in advance of a payment date would expose 95% of the MMF redemption to the risk that the bank holding the redemption proceeds would fail. In the context of payroll expenses, which can be in the millions of dollars for large companies, a 30-day exposure to this counterparty risk would be imprudent for a cash manager to permit.

Instead of issuing a redemption request 30 days in advance of a payroll date, businesses may instead respond by "grossing up" the redemption request by approximately 5.26% so that, after application of the 5% holdback, they receive the targeted payroll expenses.<sup>2</sup> For example, a company that needs to make payroll expenses of \$10 million on a given date could place a redemption order on the payment date for approximately \$10,526,300 in order to receive \$10 million of redemption proceeds on a same-day basis. While this workaround may allow businesses to avoid the issues associated with making redemption requests 30 days in advance, a gross-up strategy would greatly complicate a company's cash management practices. The amounts held back would be essentially "floating" and unavailable for use by the company to meet other obligations. Moreover, holdback periods for prior redemption requests would be continually expiring. Thus, in order to achieve a clear picture of its available cash balance at a given time, a company would have to track amounts subject to the holdback on a daily basis. Currently, business accounting platforms are not programmed to handle the processing of MMF holdbacks. Any tracking of amounts going on and off holdback would have to be done manually, resulting in an increase in expenses for manual processing and reconciliation.

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<sup>2</sup> In order for the net payment amount to be paid in full on the initial redemption date, the amount must be grossed up by 5.26%, because the 5% holdback would be measured against the grossed up amount, rather than the net amount.

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In addition, use by corporate treasurers and the other institutional users described below of MMFs as a cash management tool is reliant in significant part on the treatment of MMFs as “cash equivalents” under accounting standards. This treatment of MMFs as a cash equivalent would be undermined by changes to the Commission’s rules governing MMFs that impose a holdback requirement, redemption fee or other changes that effectively limit the daily redemption rights of MMFs.

## **2. Corporate and Institutional Operating Cash Balances**

In addition to payroll balances, companies have other cash balances generated from receivables and operations, and they closely manage those cash balances in order to meet their payment obligations as they occur. Large companies typically have a corporate treasury management function to handle liquidity needs and short-term investment of the company’s assets.

The balances involved at a company at any given time can be very large. Due to low (or zero) interest rates on short-term corporate deposits and the risk of bank failure when balances are in excess of the \$250,000 FDIC deposit insurance limits, leaving large amounts of cash on deposit at a bank is not a good alternative. Although the FDIC deposit insurance coverage on non-interest bearing demand deposits has been temporarily increased to an unlimited amount until December 31, 2012, that remains a short-term and not a highly attractive solution for corporate treasurers for holding large cash balances.

Traditionally, larger corporate treasury departments managed cash balances by holding separately managed portfolios of direct investments in commercial paper, treasury bills, and other high quality short-term debt instruments. Many corporate treasurers have found it more efficient to invest a portion of those short-term balances in MMFs. This allows for professional management at a lower cost of a diverse portfolio with greater liquidity than the company’s treasury desk could accomplish on its own. In this context, MMFs are an alternative to an individually-managed portfolio of securities.

Same-day processing of the entire amount of MMF share redemptions, which is not possible with a holdback requirement, allows MMFs to be used more efficiently by corporate treasurers and permits a more automated interface among the internal accounting systems used by the corporate treasury department, the banks through which the company sends and receives payments, and the MMF’s transfer agent. This, in turn, reduces float in the system and the balances of the corporation with its banks in excess of FDIC deposit insurance limits.

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As in the case of payroll processing, businesses may respond to a holdback requirement by grossing up a redemption request in order to receive the appropriate amount of MMF proceeds on an as-needed basis. Alternatively, they may attempt to issue redemption orders 30 days in advance of a payment obligation. Both options are fraught with problems and would severely complicate businesses' cash management practices. Consider, for example, a business that has a \$1 million lease payment due on day 1, and a \$10 million invoice due on day 10, and payroll expenses of \$20 million due on day 14 of a given month. If the business were to submit redemption orders that had been grossed up in order to receive the 100% of the amounts due on the respective payment dates, approximately \$1.63 million of its liquidity balances would be "floating," subject to three separate holdbacks and otherwise unavailable for application towards other immediate payment obligations. This results from just three payments over the course of two weeks. For businesses that engage in a large number of high dollar transactions within a 30 day period, a sizable portion of their liquidity balances may become tied up in these floating balances, exerting pressure on a company's cash conversion cycle and possibly making it more difficult to meet its payment obligations on time.

Another consequence of issuing redemption requests 30 days in advance or grossing up redemption requests is that the holdback period on each redemption would expire on a different date in the subsequent month. While this may be simple to track for the three transactions described above, most businesses would have a far greater number of payment obligations within a 30-day period, with amounts coming off the holdback period and becoming newly subject to the holdback on a continuous basis. The ability to precisely determine a company's available cash balance—that is, cash not subject to a holdback requirement—at a given time would entail a costly, time-consuming and error-prone manual tracking process.

Lastly, the intermittent release of 5% of previous MMF redemption requests from the 30-day holdback would create another cash management problem for companies. They must decide what to do with the released proceeds. In some cases, they may be able to apply the proceeds towards other immediate payment obligations. In other cases, they may deposit them in bank accounts. They may even immediately return them to the MMF funds from which they came. Companies that issue frequent redemption requests—a common practice among large organizations—would incur substantial burdens in manually reallocating redemption proceeds as they are released from holdback periods at different times and in varying amounts.

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### **3. Bank Trust Accounting Systems**

Bank trust departments are responsible for receiving, tracking, accounting for, holding in custody, investing, and paying out cash balances for large numbers of trust accounts. This cash includes balances from many different trust and fiduciary accounts. It represents cash received from the proceeds of sales of securities or other assets, dividends and interest on client investments, and new balances placed in trust. The cash is held briefly pending distribution to beneficial owners, payment of expenses and taxes on behalf of clients, and payments for purchases of securities and other assets for client fiduciary accounts. Trust departments have an obligation to keep trust assets productive, minimize the time cash balances remain uninvested, and seek a competitive return on cash balances consistent with prudent investment principles.<sup>3</sup> One of the first major uses of MMFs was to hold these trust department temporary cash balances.

In order to minimize idle cash balances, trust departments have established process flows that allocate cash balances to productive investments as opportunities arise. Imposition of a holdback requirement on MMFs would disrupt these processes. Furthermore, as described above in the case of corporate operating balances, a holdback requirement would obscure the precise amount of cash available to the trust department for investment. Trust departments would have to engage in a manual process of reconciliation in order to determine their available cash balances.

Tracking, investing and accounting for these cash balances is a complex effort, due to the large numbers of fiduciary accounts that must be tracked, the many and varied inbound and outbound streams of cash, the need to plan and manage payments and distributions for the various client accounts, tax considerations, the non-uniform provisions of the many different trust instruments that govern the requirements of each different account, and the complex and overlapping requirements of state and federal laws governing fiduciary accounts. Fiduciary laws in many jurisdictions designate certain types of assets as permitted investments for trusts and certain other fiduciary accounts. MMFs have been recognized as permitted fiduciary investments in many states.<sup>4</sup> A change to the regulatory requirements for MMFs that imposed a holdback requirement would require state fiduciary statutes to be amended by state legislatures to permit the continued use of MMFs to hold trust cash balances in certain states.

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<sup>3</sup> 12 C.F.R. § 9.10.

<sup>4</sup> See, e.g., Ala. Code § 19-4A-3; Cal. Prob. Code § 9730; Fla. Stat. Ann. § 736.0816.

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Most bank trust departments operate on trust accounting systems provided by one of ten large national vendors. These automated, computer-based systems are designed to maintain records of client accounts, generate internal and external reports used by the trust department, as well as tax records and client statements, and interact with the investment and cash management programs of the bank on an automated basis. Trust accounting systems interface with many different external systems on a daily basis. These include interfaces with systems of broker-dealer firms through which the trust department executes purchases and sales of securities for fiduciary accounts, systems providing notification of dividend and interest payments received through securities clearinghouses and payment agent banks, and systems for receiving and sending incoming and outbound payments through the banking system on behalf of fiduciary accounts. These electronic data communications generally involve a bilateral exchange of pending payment amounts stated in dollars and cents, which are followed subsequently by deliveries of those amounts. A holdback requirement would severely disrupt these automated settlement processes and would require counterparties to manually confirm settlement amounts and available balances.

In order to reduce errors and cash shortfalls, trust accounting systems typically post a debit to the cash position in the account immediately before or simultaneously with the placement of an order to purchase a security, which is transformed into a redemption order for shares of the MMF to generate cash to pay, the next day, for the security being purchased. If any part of the desired redemption amount is subject to a holdback, there will not be enough funds available to settle the purchase, and the transaction will fail.

Forcing MMFs to hold back a portion of redemptions would make MMFs incompatible with the major trust accounting systems. Until these trust accounting systems could be redesigned and reprogrammed to handle holdbacks (assuming it could be done at all, local fiduciary law permitted use of MMFs subject to a holdback, and trust departments would accept it) or to use some other vehicle to hold cash balances, trust departments would essentially be forced to use more manual processing, returning them essentially to the 1970s. Having been involved in the state legislative efforts that resulted in the expansion of local fiduciary law to permit investments in MMFs, our client believes that many of these laws preclude trust investment in MMFs that had a fluctuating NAV or were subject to a holdback or would be amended to preclude their use.

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#### 4. Federal, State, Local Government Cash Balances

Like businesses, governments have cash management needs. Many state, local and federal government bodies use MMFs as an efficient means to invest short-term liquidity balances. Governments have payrolls to pay and operating cash balances to invest for short and medium periods of time. Government cash balances often are tied to tax payment cycles and expenditures tied to fiscal year budgets; imposition of a holdback would burden a multitude of governmental agencies—at all levels of government—with the need to redesign their internal processes and timelines in order to account for the 30-day delay in receiving the full amount of redemption proceeds.

Investment of government cash balances is subject to a myriad of state and local government requirements on investment of government assets, and in some cases to Internal Revenue Service requirements. These state and local laws commonly include lists of permitted investments that specifically authorize investments in MMFs.<sup>5</sup> Imposition of a holdback requirement on MMFs would result in a change to the facts on which state legislatures and local governments relied when amending their laws to authorize MMFs as lawful investments, potentially resulting in MMFs no longer being considered lawful investments in which to store short-term balances, in light of the reduced liquidity created by the holdback period.

Although placing the funds on deposit at a bank is an alternative, government deposits frequently are required to be collateralized with high quality bonds,<sup>6</sup> which make them expensive for the bank to hold. Another alternative is for the state or local government to attempt to manage a portfolio of direct investments in individual money market instruments, although this is a more expensive, higher risk and ultimately less liquid means of investing cash balances of state and local governments than investing in MMFs. An unintended consequence of a holdback requirement would be to preclude many state and local governments from using MMFs and to force them into less liquid, more expensive, higher risk alternatives for investment of cash portfolios.

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<sup>5</sup> See, e.g., N.J. STAT. ANN. § 18A:20-37; S.C. CODE ANN. §§ 6-5-10(6), 12-45-220; Tex. Gov't Code Ann. § 2256.014 (West); COLO. REV. STAT. § 24-75-601; CONN. GEN. STATS. § 7-400(1)(B); MICH. COMP. LAW. §§ 129.91, 129.93; Op. Ind. A.G. No. 96-3 (Sept. 5, 1996).

<sup>6</sup> 12 U.S.C. §§ 1821(a)(2), 1823(e)(2).

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## **5. Municipal Bond Trustee Cash Management Systems**

State and local governments raise money for general operations and for specific projects through the issuance of municipal bonds. Leaving large amounts of cash on deposit at a bank results in a concentration of credit exposure that in some cases is not acceptable to bondholders. In addition, because the liquidity balances flow through the bond trustee and payment agent over relatively short periods of time, a bank may not be able to profitably invest the cash on a short-term basis. As a result, MMFs are used in many cases to hold portions of the short-term liquidity pending payment or distribution on scheduled dates.

Each bond issuance has an indenture with a bank as bond indenture trustee and payment agent to handle various aspects of the bond's issuance, payment of interest and ultimate retirement. Substantial cash balances flow through the bond trustee and paying agent bank, with which cash payment must be made on time every time pursuant to the contractual terms of the bonds to avoid default. A holdback requirement will require the on-time payment terms embedded in existing indentures to be modified to take into account the fact that the full amount of redemption proceeds would not be available until expiration of the holdback period, which as a practical matter is not a modification that investors will accept. The accounting systems used by the paying agent bank would also need to be modified in order to handle any sort of holdback requirement.

The trust indenture of the bond, as well as state and local government laws and IRS requirements dictate certain aspects of how and into what types of assets the cash balances can be invested pending payment or distribution. A holdback requirement will require amendment of various trust indentures as well as state, local and IRS regulations in order to permit the continued investment in MMFs of cash balances that are pending distribution to bondholders.

In many cases, the credit quality and credit rating of the bond issuance is tied to a very carefully developed cash management program designed to assure that there will be cash available to make scheduled interest payments and sinking fund retirements of the bonds. A holdback requirement that decreased the liquidity of the funds used to make distributions to bondholders could have implications for the credit ratings of municipal bond issuances.

Same-day processing of the entire amount of MMF share redemptions, which is not possible with a holdback requirement, allows MMFs to be used more efficiently by the bond trustee and payment agent. This, in turn, lowers the exposure of the bond

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trustee to the counterparty risk of holding issuer balances in a bank deposit account in excess of FDIC deposit insurance limits.

## **6. Consumer Receivable Securitization Cash Processing**

The structures used for issuance of mortgage-backed bonds and other securitizations of consumer receivables share some of the attributes and cash management needs of municipal revenue bonds, but the cash flows are far more complicated and less predictable. Many of the structures require an initial cash balance and additional retention, build-up and holdback of significant amounts of cash from payments received on the underlying consumer receivables as a “prefunded account” in order to assure timely payment of the senior tranches of the securitization.<sup>7</sup>

MMFs are used in some cases to hold portions of these cash balances, for essentially the same reasons described above: MMFs limit counterparty risk exposure to any one bank, and the absence of any holdback requirement permits same-day processing of share redemptions and more convenient inclusion of balances in the complex accounting systems needed to track payments and disbursements in these securitization structures. A holdback requirement would interfere with the ability to make timely payments to the investors in a securitization.

The permitted instruments into which cash balances can be invested generally are specified in the trust indenture and other governing documents of the structure and cannot readily be changed after the securitization structure is launched and its securities sold to investors. Changing the regulatory attributes of MMFs would compromise their role in holding short-term liquid assets in securitization structures.

## **7. Escrow Processing**

Money is placed in escrow in connection with a variety of transactions ranging from the purchase of a home to corporate acquisitions. The basic purpose is similar—to place a cash balance into the hands of an independent party to make a payment on a contractually specified amount when certain conditions are met. The amounts per customer may be a few thousand dollars for mortgage escrows to hold tax and insurance payments, or billions of dollars in a corporate merger. The funds may be held for a few hours, days or months. The amounts held by an escrow agent commonly exceed deposit insurance limits of \$250,000. If pass-through deposit insurance treatment is not

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<sup>7</sup> See *Federated Investors, Inc.*, SEC Staff Letter 1997 SEC No-Act LEXIS 716 (July 8, 1997).

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available, or if the amounts per ultimate beneficial owner exceed \$250,000, allowing the escrow agent to place the escrow balance in a bank deposit may not be an acceptable risk to the parties. Escrow agreements commonly allow the parties to direct the escrow balances be held in shares of a designated MMF as a way of limiting counterparty risk.

MMFs are useful for this purpose because they do not represent the credit risk of a single issuer, but instead represent a diversified pool of high-quality short-term debt obligations of many underlying issuers. In addition, because the value of the shares do not fluctuate, the escrow agent can hold an amount representing exactly what must be paid if the conditions for payment are met.

The lack of a holdback requirement permits the redemption of an MMF to be settled in its entirety on the same day. This is key to the utility of MMFs to hold temporary cash balances for escrow agents. If a holdback requirement of, for example, 30 days was imposed on MMFs, they would become essentially useless to escrow agents. Escrow agents require the ability to redeem their investments on short notice in the event an escrow fund must be drawn upon, the occurrence of which cannot always be predicted in advance. The lack of total liquidity created by a holdback requirement would nullify a key feature of MMFs on which escrow agents rely.

Escrow agents that process mortgage-related tax and insurance payments use complex automated accounting systems that must track and account for a large number of consumer escrow accounts, each with different balances and payment amounts. Tax and insurance payments must be made with considerable frequency across the set of an escrow agent's mortgagor clients, requiring individual MMF redemption requests on a continuous basis. The process of modifying these accounting systems to track the associated holdbacks would be extremely burdensome and costly. Furthermore, since only 95% of the escrowed tax/insurance payments would be liquid at a given time, mortgagors may be required to deposit additional amounts into escrow to permit the escrow agents to "gross up" a redemption request so they can fulfill the entire amount of the payment obligations on the mortgaged property when due.

## **8. 401(k) and 403(b) Employee Benefit Plan Processing**

Private employers over the past few decades have shifted from defined benefit retirement plans to defined contribution plans due to the high costs and potentially large unfunded liabilities associated with defined contribution plans. Two common and highly popular forms of participant-directed defined contribution plans are 401(k) and 403(b) plans.

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Among the requirements applicable to these plans under the Department of Labor rules implementing the Employee Retirement Income Security Act (“ERISA”) are that, in order to limit the liability of plan trustees, a stable value option be included as part of the plan to hold cash contributions for which a participant has not yet provided investment instructions.<sup>8</sup> MMFs are an investment option eligible to meet this requirement for up to 120 days. In addition, cash balances in participant accounts must be segregated from the assets of the plan trustee and held during brief periods of time when a plan participant is changing the investment allocation of the participant’s account. MMFs serve this purpose within 401(k) and 403(b) plans.

Where the plan’s assets are managed by a plan fiduciary, the plan may use a MMF to hold its uninvested cash. A common arrangement is for the plan’s custodian to “sweep” uninvested cash in the plan’s accounts at the end of each business day into a designated MMF. The cash remains in the MMF until the plan fiduciaries determine how to allocate that cash to other investments, or the cash may be held to pay upcoming plan distributions or expenses. In addition, the MMF can be used to temporarily hold proceeds from a liquidated investment pending the availability of a new investment; to hold incoming employer contributions that have not yet been allocated to long-term investments; or to hold amounts set aside to pay for an upcoming investment obligation.

Moreover, a MMF may be used as the short-term fixed-income or cash investment vehicle under a plan’s overall asset allocation. This may be the case in a fiduciary-managed plan, or part of the line-up of investment options for a participant-directed individual account plan. In the case of a participant-directed plan, it would serve as the most conservative investment option (or one of the most conservative investment options, along with a stable value fund or similar investment) in terms of risk and reward characteristics (lowest risk, lowest reward) in the spectrum of the plan’s investment line-up.

A MMF offers two features that work well for both of these purposes. First, it maintains a constant net asset value of \$1.00 per share, which does not decrease except in extraordinary circumstances. Therefore, cash invested in a MMF is subject to minimal risk, which is important if the cash is being held to meet an upcoming investment or payment obligation of a fixed amount. Second, a MMF is highly liquid, with the ability

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<sup>8</sup> See 29 C.F.R. § 2550.404c-5 (Department of Labor Qualified Default Investment Alternative Regulations).

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to redeem invested assets out of the fund on any business day. It offers the flexibility for use on short notice to meet any cash need that may arise.

Imposition of a holdback requirement would undermine the high degree of liquidity of MMFs that has been central to the permitted use of MMFs to hold participant funds on a temporary basis. The lack of a holdback requirement permits investors to redeem the entirety of their MMF holdings on the same day. If MMFs were required to hold back a portion of the desired redemption amount, plan trustees would have to wait for the holdback period to expire before they could fully effect a transaction within 401(k) and 403(b) plans. This would limit the usefulness of MMFs as a store of value during the period that participant investment instructions are pending. This would also limit the utility of MMFs for use with the automated accounting and processing systems used by vendors that provide 401(k) and 403(b) plans and, if MMFs continued to be used at all, would increase settlement times and float in the system.

In addition, the MMF “reforms” currently under discussion would affect whether and the manner in which pension and employee benefit plans that are subject to ERISA would be able to use MMFs. The fiduciary duty to act in a prudent manner under section 404(a)(1)(B) of ERISA is the basic standard that governs ERISA plan investments. This section provides that a fiduciary must discharge its duties to the plan “with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims.” The prudence standard has been interpreted as creating a responsibility for a plan fiduciary to act in a procedurally proper manner, based on an objective standard, through giving appropriate consideration to the facts and circumstances relevant to a particular investment decision and acting accordingly, in a manner as would others acting in similar capacity who have a familiarity with such matters.

The two basic roles served by MMFs for ERISA plans are as a cash holding vehicle, or as the short-term fixed-income or cash investment option for asset allocation purposes. These roles could be affected by the changes to MMF regulation that are under discussion.

The set-aside of capital reserves for MMFs would have an effect on yield. While it would not appear to affect the day-to-day operation of the fund, the presence of the capital reserve buffer may, depending on how it is structured, decrease the yield rate from time to time. As part of its prudence review, a plan fiduciary would be required to consider the nature of a MMF’s capital reserve and how it affects the MMF’s yield. This

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would require a period of adjustment, for fiduciaries to determine the appropriate analysis to use and how to interpret and apply the results of that analysis. To the extent they determine that the capital reserve structure would risk an adverse effect on yield, it could discourage plan investment.

The second part of the proposal – the holdback rule – would have a direct impact. It would mean that in the event a plan fiduciary or plan participant decided to withdraw completely from the fund, a portion of the plan’s or participant’s investment would be withheld for a period of time. This would affect the plan’s ability to reallocate assets in accordance with the fiduciary’s or participant’s investment decisions, or to make a distribution to a terminated employee or retiree.

In the case of a fiduciary-managed plan that uses a MMF to hold its cash, this would mean that the plan fiduciary would be required to set aside extra cash to ensure that it can cover the plan’s upcoming investment or payment obligations. In addition to necessitating more advanced planning of how to meet the plan’s obligations, it would result in additional assets remaining “uninvested” in cash for longer periods of time, with the potential effect of reducing investment returns.<sup>9</sup>

For a plan with significant cash moving through the MMF on a temporary basis pending investment, reinvestment, reallocation, or distribution, (a common situation) the 5% holdback would quickly build up over the course of each 30-day period to a large percentage of the cash balance, because, as noted elsewhere in this letter, the holdback being considered by the Commission would be on gross amounts withdrawn from the MMF by the plan over the preceding 30 days, not on the net amount that the plan has invested in the MMF during that period.

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<sup>9</sup> Another possible effect is on plan fiduciaries that, in the course of managing plan investments, cause plan assets to be invested in their proprietary mutual funds. While such investments could violate the ERISA prohibited transaction rules, they are exempt if the investment manager complies with the conditions of Prohibited Transaction Exemption 77-4. One of these conditions is approval by a plan fiduciary who is independent of the investment manager. While this exemption does not specifically address what must occur in the event the independent fiduciary wishes to terminate its approval, Department of Labor might take the position that to avoid undermining this condition, the approval must be terminable at any time without penalty, based on the requirements in other exemptions. *See, e.g.*, Prohibited Transaction Exemption 86-128, § III(c); 29 C.F.R. § 2550.408b-2(c). If the holdback were treated as a “penalty,” the ability to comply with the independent approval condition of the exemption for investments in MMFs could be affected.

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In the case of a participant-directed plan, the holdback rule would be a restriction on the ability of plan participants to withdraw their individual account assets from a plan investment option. This could affect the ability of the plan to comply with the conditions of the section 404(c) exception from the ERISA fiduciary responsibility rules for participant-directed investments. One of the requirements of that exception is that the participants be able to give investment instructions regarding an investment alternative with a frequency that is commensurate with the investment's reasonably expected market volatility – the more volatile the investment, the more frequently a participant should be able to invest or withdraw his or her money (referred to as the “general volatility rule”). Given the limited guidance on the application of the general volatility rule, it is not clear how it would apply to a 30-day holdback restriction. This would create uncertainty and potentially jeopardize the plan's section 404(c) status (at least as to investments in the MMF option).

Even if section 404(c) compliance were not an issue, there could be a question for fiduciaries as to whether the MMF continues to fulfill the role of a conservative investment option in the plan's line-up. The participants could now arguably be at risk for the amount of the holdback. At the very least, the holdback requirement would have to be disclosed to the plan participants, so that they can evaluate the effect when investing in the fund, necessitating revisions of existing disclosure documents.

The holdback would also affect the ability of the fiduciaries of a participant-directed plan to change investment options. According to Department of Labor interpretations of ERISA, these fiduciaries have a responsibility to prudently monitor whether the plan's investment options continue to be appropriate investments for the plan. If the fiduciaries determine that a MMF is no longer a prudent investment, then they would be obligated to terminate the investment and transfer the invested funds to a replacement investment option. The holdback would complicate the process for withdrawing the funds, likely requiring the plan to impose an extended “blackout” period during which plan participants are not permitted to make transfers of the held-back portion of their account assets for the 30-day period. In addition to necessitating compliance with rules requiring advance notice of the blackout period to the plan participants, this creates a situation in which plan fiduciaries have determined that an investment option is no longer prudent, but participants are nevertheless locked in for at least another 30 days. The plan's continued investment in an option labeled as imprudent could put the fiduciaries at risk of liability for the held-back amounts. The same issues would arise for fiduciary-managed plans, where the plan fiduciaries determine that investment in a particular MMF is no longer prudent – they also would be locked in for part of their investment after having determined the investment to be imprudent. Plan

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fiduciaries will be reluctant to make an investment that could readily expose them to liability for a percentage of the investment.

The imposition of redemption fees would raise more serious questions for plan fiduciaries. Instead of causing a delay in the receipt of withdrawal proceeds, they would instead diminish the plan's proceeds, with no ability to eventually recover the difference. Plan fiduciaries may not find it prudent to use a MMF to hold the plan's uninvested cash, or as the plan's most conservative investment option, if there is a prospect that the plan could suffer a loss. While they could take a chance that the events triggering redemption fees will not occur for a particular fund, they may risk fiduciary liability if those events did occur and resulted in a loss to the plan or plan participant accounts, with participants complaining that the fiduciaries should have anticipated those trigger events and withdrawn plan assets from the MMF before they occurred.<sup>10</sup>

If plan fiduciaries determine that the plan should no longer hold shares of MMFs for these reasons, they would be forced to look for alternatives. The other common form of short-term cash investment is bank deposits. Bank deposits may work for cash sweeps, subject to considerations regarding the availability of FDIC insurance and the ability to diversify among different banks to decrease risk. However, it is not clear how well bank deposits would work for participant-directed plans. While electronic trading platforms have developed to facilitate participant-directed trades in mutual fund shares, there is no such mechanism for bank deposits. Consequently, there may not be a readily available alternative to MMFs for participant-directed plans.<sup>11</sup>

The changes to the rules for MMFs that are being discussed could have serious consequences for ERISA plans. The Commission should not proceed with changes to the

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<sup>10</sup> In addition, the imposition of redemption fees could raise a compliance issue under Prohibited Transaction Exemption 77-4, the exemption for investments in a manager's proprietary mutual funds described in footnote 9 above. The exemption does not permit a plan to pay a redemption fee on selling shares of a mutual fund unless, among other things, the existence of the redemption fee is disclosed in the prospectuses in effect both at the time the plan purchased the shares and at the time of the sale. A newly-imposed redemption fee may not meet this condition, resulting in a violation of the exemption.

<sup>11</sup> Participant-directed plans also commonly use bank collective investment funds as investment options, so they could have the option of replacing their MMFs with bank collective funds that operate like MMFs. However, comments to the SEC have suggested that all money market funds should be subject to similar restrictions, in which case the same problems could arise for bank collective funds that invest in money market assets as well.

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rules for MMFs without addressing the effect on qualified pension and employee benefit plans.

### **9. Broker-Dealer Customer Cash Balances**

Customer accounts at securities broker-dealers carry cash balances that are used to make payments on amounts owed by the customer on purchases of securities. This cash belongs to the brokerage customer. Cash flows into the brokerage account through cash amounts added to the account by the customer, dividends and interest on investments held in the account, and the proceeds of sales of securities.

If the brokerage customer's cash balance is not invested in something, it sits as a "free credit balance" which is simply a "due to" amount owed to the customer by the brokerage firm. To protect customers against the risk of a failure of the broker-dealer firm (and ultimately Securities Investor Protection Corporation, which guarantees customer cash balances up to \$250,000 per account), the broker-dealer is required to hold bank deposits or certain types of securities in a segregated account for the exclusive benefit of its customers in an amount at least equal to the net unencumbered amounts of customer "free credit balances."<sup>12</sup>

As an alternative to holding customer cash as free credit balance liabilities of the broker-dealer, brokerage firms normally provide a cash sweep program by which customer cash balances are "swept" into investments in shares of MMFs which are then owned by the customer but held in custody through the broker-dealer. Investment of the cash balances into MMF shares segregates these customer assets from the assets of the broker-dealer and removes them from the balance sheet liabilities of the broker-dealer.

Because MMF redemptions settle same-day (T+0), cash is available very quickly to pay for customer purchases of securities, or to receive incoming cash from the sale by the customer of a security. This same-day cash availability is important to avoid customer "fails," and to assure compliance with the margin rule requirements applicable to brokerage accounts which require cash availability in the account when a customer places an order in a customer cash account and margin collateral coverage in a customer margin account.<sup>13</sup> The ability to redeem 100% of a desired MMF share amount on a

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<sup>12</sup> 17 C.F.R. § 240.15c3-3.

<sup>13</sup> See Regulation T, 12 C.F.R. § 220. The margin rule treats MMFs shares essentially as the equivalent of cash for this purpose.

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same-day basis, without any holdback, is a crucial feature of MMFs that enables their holding of cash balances in brokerage accounts. This also allows the use of MMFs within the automated accounting and transaction processing systems used by the broker-dealers, which in turn reduces settlement times, pending transaction float balances and fails, and counterparty risk in the system.

If a holdback requirement is applied, frequent MMF redemption requests would greatly complicate the calculations necessary to determine the balance of funds immediately available for investment by a customer. A holdback requirement would also make it difficult for broker-dealers and customers to know the precise amount of cash in an account, which is important for ensuring compliance with margin requirements. Broker-dealers would need to install new recordkeeping systems capable of tracking holdback amounts as funds are entered into and released from holdback status.

Most importantly, holdbacks on frequent redemption requests would greatly reduce the capital available for investment by a customer. For example, an active retail or corporate investor who redeems all his MMF investments each morning to fund the day's trading activity, only to close all positions before the end of the trading day so the funds can be reinvested in MMFs through a nightly sweep, would see his available trading balance diminish by 5% each day. That is, each subsequent morning's redemption request would cause an extra 5% of his funds to enter into holdback status, rendering those funds unavailable to him for 30 days. After 10 days of making a daily redemption request for the investor's entire account balance, 40% of his original capital would be tied up in holdbacks. After 30 days of this behavior, an astounding 79% of the investor's original capital would no longer be accessible for investment. Assuming the investor ceased making MMF redemptions during the following month, his investable balances would slowly recover, day by day, as proceeds were released from holdback status.

While the example above is highly stylized, actual investor can be far more complicated, with active traders and hedge funds making multiple MMF redemption requests per day. Even a less active trader who redeemed his MMF portfolio only twice a week would lose access to one-third of his available funds at the end of a 30-day period. Unchecked, this kind of activity could deprive an investor of access to most of his capital. Imposition of a holdback requirement would thus impede the basic purposes for which MMFs are used in brokerage accounts, and investors may choose instead to leave uninvested balances as free credit balances. A mass exodus out of MMF sweep accounts into free credit balances would bloat the balance sheets of broker-dealers, as they would be forced to record additional liabilities to reflect those free-credit balances.

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## 10. Futures Dealer Customer Cash Balances

Rules of the Commodity Futures Trading Commission (“CFTC”) require the segregation of customer cash balances at a futures firm used to pay for (and provide margin collateral for) futures transactions placed by a customer.<sup>14</sup> MMFs serve the same function at futures firms as they serve at securities broker-dealers—to hold customer cash balances and to collateralize amounts due or potentially due on futures positions of the customer held through the futures firm. The CFTC reaffirmed the continued appropriateness of MMFs to hold customer liquidity balances in December 2011 after careful review and a lengthy rulemaking proceeding.<sup>15</sup> The CFTC determined through this process that MMFs satisfy the statutory objective that “customer segregated funds must be invested in a manner that minimizes their exposure to credit, liquidity, and market risks both to preserve their availability to customers ... and to enable investments to be quickly converted to cash at a predictable value in order to avoid systemic risk”<sup>16</sup> as well as the Regulation 1.25 prudential standard that all permitted investments be “consistent with the objectives of preserving principal and maintaining liquidity.”<sup>17</sup>

Specifically, Regulation 1.25 states that, with limited exceptions, MMFs in which customer funds are invested are “legally obligated to redeem an interest and to make payment in satisfaction thereof by the business day following a redemption request.”<sup>18</sup> Only extreme situations such as non-routine closure of the New York Stock Exchange or declaration of a “market emergency” by the Commission are permitted as exceptions to this next-day redemption requirement.<sup>19</sup> Imposition of a holdback requirement would directly conflict with this CFTC requirement for next-day liquidity and would prevent futures commission merchants from investing any customer funds in MMFs.

Broker-dealers and futures dealers are subject to regulatory requirements specifying the types of assets that the entity can own and the types of assets that can serve as collateral or be used to invest client cash balances. Many of these regulatory

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<sup>14</sup> 17 C.F.R. § 1.20.

<sup>15</sup> CFTC, *Investment of Customer Funds and Funds Held in an Account for Foreign Futures*, 76 Fed. Reg. 78776 (Dec. 5, 2011).

<sup>16</sup> *Id.* at 5.

<sup>17</sup> *Id.* at 6, citing 17 C.F.R. § 1.25(b).

<sup>18</sup> 17 C.F.R. § 1.25(c)(5)(i).

<sup>19</sup> 17 C.F.R. § 1.25(c)(5)(ii).

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provisions specifically include as a permitted investment MMF shares that seek to maintain a stable net asset value per share.<sup>20</sup> The ability of securities broker-dealers and futures commission merchants to shorten settlement times and reduce the systemic risks associated with unsettled transactions has been facilitated by the ability of MMFs to process purchases and redemptions of shares on a same-day (T+0) basis, which in turn is only possible as a result the ability of MMFs to be redeemed without any holdback. Requiring MMFs to hold back a portion of a requested redemption would lengthen settlement times of securities transactions by the length of the holdback period. Even a holdback period of a single day would present an unworkable delay in settlement. The securities industry has spent the past 35 years shortening settlement times to in order to reduce systemic risk. Using MMFs to hold short-term cash balances in connection with the transaction settlement process has been an integral part of how that was accomplished. An unintended consequence of the imposition of a holdback requirement would be impractically long securities transaction settlement cycles and an increase in systemic risk.

## **11. Investment of Cash Collateral for Cleared and Uncleared Swap Transactions**

MMFs are critical to the implementation of Title VII of the Dodd-Frank Act, which mandates the regulation and centralized clearing of most swaps transactions. With the approval of the CFTC, MMFs are playing an important role as a vehicle to hold collateral for swaps transactions. Recently adopted CFTC Rules 22.2(e)(1) and 22.3(d), and proposed CFTC Rule 23.603 will regulate swaps and other derivatives that are cleared through the facilities of a registered derivatives clearing organization. Under these rules, the investment of collateral posted to secure swaps and other derivative transactions will be subject to the requirements of CFTC Rule 1.25. Rule 1.25 explicitly provides that MMFs are permissible investments for such collateral. As determined by the CFTC in its recent amendment of Rule 1.25 and adoption of Rules 22(e)(1) and 22.3(d) (and as reflected in proposed Rule 23.603), MMFs are effective in filling this function because they are very liquid, maintain credit quality and diversify risk across many issuers held in the portfolio of the MMFs, which protects collateral from loss.

Imposition of a holdback requirement would undermine the liquidity of MMFs, directly conflicting with the Rule 1.25 requirement for next-day redemption. This would

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<sup>20</sup> N.Y. Mercantile Exchange Letter to Mr. Richard Recker, Federated Securities Corp. (May 18, 2001); Options Clearing Corp. Memorandum to all Clearing Members (Feb. 18, 2005).

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preclude the use of MMFs as collateral for cleared swaps transactions.<sup>21</sup> Holdbacks will also make the process of tracking and posting a large volume of transactions far more difficult. Imposing a holdback requirement on MMFs would undermine the use of MMFs in holding collateral for swaps transactions and would run counter to ongoing efforts to reduce risk in the swaps markets in a manner consistent with the central goals of Title VII of the Dodd-Frank Act.

## **12. Cash-Management Type Accounts at Banks and Broker-Dealers**

Brokerage firms and banks offer “cash management” type accounts that permit customers to access cash balances in their brokerage accounts by check or debit card. Millions of retail customers find these accounts to be convenient. Cash balances in these accounts are held either in MMFs or in brokered deposits at banks. Checks and debit cards are processed by a bank for the brokerage firm. The payments of these items are funded by cash received from redemptions of MMF shares held in the customer’s brokerage account. The bank runs nightly files of items presented for payment, which triggers a redemption of MMF shares. The bank advances payment on the items after confirming electronically MMF shares are being redeemed to repay the bank on the advance of Funds. The cash from the redemptions is then sent to the bank.

Banks offer a substantially similar product without the brokerage account. In the bank version, the bank offers a checking account with a debit card and ATM access, with balances above a set dollar minimum (which often is \$0) swept into shares of an MMF.<sup>22</sup> The bank pays items after they are presented and after verifying there are enough MMF shares owned by the Customer. The bank places an order to redeem MMF shares to repay the advance. Processing the transactions is done on an automated basis, requiring a series of electronic data exchanges among the bank that issues the debit card and processes the checks, the brokerage firm or bank that carries the customer’s brokerage account, and the transfer agent of the MMF which processes the redemption requests and forwards payment to the bank. A holdback requirement would interfere with these automated processes, which are not programmed to handle holdbacks. Companies would have to resort to manual verification of available balances by directly contacting their counterparties.

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<sup>21</sup> See note 17, *supra*, and accompanying text.

<sup>22</sup> See Securities Exchange Act of 1934, § 3(a)(4)(B)(v) (MMF sweep account exemption for banks in definition of securities “broker”); Regulation R, 12 C.F.R. § 218.741 (same); 17 C.F.R. § 247.741 (same).

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The ability to redeem 100% of MMF shares without a holdback period is crucial to processing these accounts because it permits same-day processing of MMF share redemptions. This allows the bank to limit its credit exposure and avoid overdrafts and “NSF” or “bounced” checks. Imposition of a holdback could thus increase a bank’s automated NSF activity, necessitating more manual downstream exception processing.

For debit cards, there is a two step-process notification and payment of items is separated by a few days. First, at point of sale, the merchant sends an electronic signal through the banking system that the customer is buying something at a certain price, and the available balance is confirmed and a hold placed on that balance at the MMF. A few hours or days later, the merchant submits the debits for payment through the banking system, which submits the items for payment to the bank that issued the debit card and which makes the payments. The bank then sends a signal to redeem the MMF shares that are on hold to repay the bank for the advance.

If same-day settlement of the entire amount of an MMF redemption were not available, the bank would not be reimbursed on the same-day that it advanced payment on the debit card items. Same-day cash would not be available to the entity “sourcing” the transaction. This would require cash flow changes throughout the funding chain and could require some participants in the process to carry an overnight overdraft until the cash arrives the next business day. The constant movement of funds into and out of holdback status would also make precise knowledge of a customer’s available cash balances difficult to ascertain such that the debit card processor would not know if there are sufficient funds to cover customer activity.

If same-day settlement of the entire amount of an MMF redemption were not available, the bank would not be reimbursed on the same-day that it advanced payment on the debit card items. Same-day cash would not be available to the entity “sourcing” the transaction. This would require cash flow changes throughout the funding chain and could require some participants in the process to carry an overnight overdraft until the cash arrives the next business day. The constant movement of funds into and out of holdback status would also make precise knowledge of a customer’s available cash balances difficult to ascertain such that the debit card processor would not know if there are sufficient funds to cover customer activity.

### **13. Portfolio Management**

Portfolio managers and investment managers rely on MMFs for the investment of the portion of the total portfolio which their asset allocation strategies direct should be

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invested in cash. Sound asset allocations frequently include a component dedicated to cash in order to reduce the risk of a portfolio and in order to provide the flexibility to divert funds into other asset classes as investment opportunities arise. The imposition of a holdback requirement would impede the ability of a portfolio manager to swiftly alter a portfolio's asset allocation by reducing the cash component and increasing the funds invested in another asset class, such as equities in order to increase the risk-reward profile of the portfolio. Portfolio managers will need to take into account the amount and timeframe of any holdback requirement as they determine the optimal asset allocations to offer their clients the flexibility and expected returns consonant with their risk tolerances.

#### **14. 529 Plans**

529 plans, named after Section 529 of the Internal Revenue Code,<sup>23</sup> are tax-advantaged investment plans that allow individuals to save for the costs of higher education. Contributions to the plans are generally tax-exempt at the state level, and principal invested in the plans grow tax-deferred, with tax-free withdrawals permitted to pay for the beneficiary's higher educational expenses. Age-based 529 plans are administered by the states and offer savers a selection of asset allocations that are attuned to the age of the beneficiary. The older the beneficiary—and closer in age to requiring disbursements for college expenses—the more conservative the asset allocation. Assets allocations typically include a high percentage of liquid assets, such as MMFs, as the beneficiary nears college-age. Imposition of a holdback requirement on MMF redemption would restrict the liquidity of portfolios, which could affect a student's ease of access to funds as he begins to need distributions to pay qualified higher educational expenses. Plan administrators may thus reduce reliance on MMFs once a beneficiary begins college or comes close to that point. If plans resort to the "gross up" method in order to fund a student's withdrawal request, then both plan participants and plan administrators would need to consider the tax consequences of any such gross-up.

#### **15. Capital Requirements and MMF Portals**

Just as a holdback requirement would have drastic repercussions for the users of MMFs, so too would the imposition of any sort of capital buffer requirement. A capital buffer that is financed by diverting fund income before distribution to shareholders would further depress already low yields on MMFs. With interest rates remaining at a historic low, treasurers and cash managers are tasked to generate a return on cash to prevent value

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<sup>23</sup> 26 U.S.C. § 529.

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erosion through inflation and rising prices. A capital buffer funded from MMF shareholder income would make MMFs unsuited to the task of preserving capital while generating yield. Corporate treasurers would be forced to seek other options, such as increased reliance on bank deposits—which would only exacerbate the exposure of businesses to the counterparty risk of systemically important financial institutions—or suffering the higher costs and decreased efficiencies of individually managing large portfolios of Treasuries, commercial paper, and other short-term debt instruments.

Alternatively, financing the capital buffer by selling equity stakes in the fund that are subordinated to the equity interests of common fund shareholders would effectively transform common MMF shareholders into depositors or creditors, who are protected against loss by a small, more junior class of shareholder, and who would be limited to an even lower, fixed yield. Either form of capital buffer would depress yields to shareholders, making MMFs less suitable for each of the applications described in the foregoing sections.

MMF portals would be particularly affected by a capital buffer requirement. MMF portals are online services that provide investors with data on and access to hundreds of different money market funds. If a capital requirement were imposed, operators of MMF portals would have to reprogram their systems to accept and report information on each fund's capital buffer, such as the type of buffer and the amount of the buffer a fund has already accumulated. This could impose substantial costs on key service providers in the MMF industry.

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It is difficult for us to ascertain the total size of each of the market segments discussed in this letter that would be adversely impacted by the changes that are currently under consideration. In total, institutional investors represent roughly two-thirds of the roughly \$2.6 trillion of investments in MMFs, and the specialized applications described above that will be adversely affected by a holdback, minimum balance requirement, redemption fee, capital requirement or floating NAV, represent a significant part of that total. Our client estimates that these segments aggregate in the hundreds of billions of dollars, and possibly more. The immediate impact could be devastating not only on MMFs and their institutional users, but also to the short-term financial markets by significantly contracting liquidity and raising the cost of capital for commercial paper issuers and issuers of tax exempt securities. Over the long term this will have the effect of forcing cash into less regulated entities or into deposits of “too big to fail” banks – a

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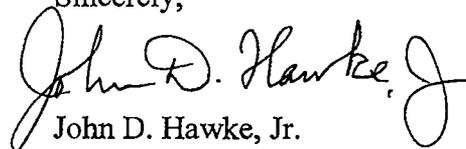
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result at odds with stated regulatory policy and the Congressional purpose underlying the Dodd-Frank Act.

The Commission's regulation and oversight of MMFs has been robust and successful, and the recent amendments to Rule 2a-7 appear to have been highly effective in enabling MMFs to weather periods of unusual redemptions during last year. However, as demonstrated by each of the MMF applications described above, imposition of a holdback requirement, minimum balance requirement, redemption fee, floating NAV or a capital requirement on MMFs would harm the multitude of businesses that have come to rely on MMFs to store short-term liquidity and would have adverse effects that would ripple throughout the economy. Under these circumstances, Federated does not believe that making further substantial changes to the regulation of MMFs at this time is warranted. Instead, a careful analysis should be conducted of the effectiveness of the 2010 amendments to Rule 2a-7 and recent enhancements to the SEC's program of oversight of MMFs to determine whether any further changes or refinements to MMF regulation are appropriate.

Sincerely,



John D. Hawke, Jr.

cc: The Honorable Mary Schapiro  
The Honorable Luis A. Aguilar  
The Honorable Daniel M. Gallagher, Jr.  
The Honorable Troy A. Paredes  
The Honorable Elisse B. Walters

Eileen Rominger, Director, Division of Investment Management  
Robert E. Plaze, Associate Director, Division of Investment Management

**Consequences of a Holdback Requirement and a Capital Requirement  
For Investors in Money Market Mutual Funds (MMFs)**

**Premises**

Money market investors rely on a stable NAV product because their current systems and processes depend upon the ability to calculate the available invested balance with certainty.

If a 5% holdback is imposed, 95% of the requested amount would be redeemable on a same-day basis; 5% of the requested redemption amount would be distributed to the shareholder 30 days after the redemption request is made.

Each redemption request is in effect two transactions, one for the initial 95% of proceeds and one for 5% of proceeds 30 days later. Investors may react by “grossing up” a given redemption request by approximately 5.26% (1 / 0.95) in order to receive 100% of the targeted redemption amount on the date of the redemption request. The subsequent receipt of the 5% holdback would be dealt with separately.

Open issues include whether:

- the 5% holdback could be reinvested into the MMF after the 30-day hold;
- the 5% holdback would be held for the duration of the 30-day period in escrow with the MMF’s transfer agent or would remain invested the MMF.

Application	Consequences
1. Corporate Payroll Processing	<ul style="list-style-type: none"> <li>• Corporations would need to issue redemption requests 30 days in advance, but the precise amount of payroll expenses cannot be known that far in advance, due to fluctuations in staffing or actual hours accrued for hourly work.</li> <li>• Corporations may need to consider “grossing up” their redemptions by 5.26% in order to initially receive the desired cash amount and then deal with the subsequent receipt, 30 days later, of the amount held back.</li> <li>• 5% of all redemptions would be effectively “floating” and unusable cash.</li> <li>• Available cash in an account would be more difficult to predict due to the need to track the 5% holdbacks. Balances would need to be calculated and reconciled daily to account for aged 5% holdback amounts rolling off of holdback status.</li> </ul>

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**Application****Consequences**

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- There would be an increase in reconciliation issues and consequently an increase in servicing and manual processing expenses.
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2. Corporate/Institutional Operating Cash
- The same-day receipt of only 95% of redemption proceeds would present reconciliation challenges.
  - Corporations would face challenges in managing and reconciling incoming cash intended to meet obligations, such as security settlements or invoice payments.
  - Corporate treasurers would experience decreased efficiency of their cash management processes.
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3. Trust Accounting
- Money funds will no longer be a permitted fiduciary investment under many state trust laws.
  - Established trust process flows for, *e.g.*, tax payments and securities purchases would be disrupted.
  - There would be an additional level of reconciliation needed to calculate/validate the cash amount available to settle these transactions.
  - Current automation between trust accounting systems and their bank's investment and cash management systems would be disrupted. Available balances could no longer be independently calculated; companies would have to depend on counterparties to confirm balances.
  - Current automation between trust accounting systems and external parties, such as broker-dealers, for the execution/settlement of security trades would be disrupted.
  - Settlement systems could no longer rely on the predictability of the cash required for settlement and of the ending available cash balance for processing additional transactions.
  - Trust accounting platforms are not designed to handle a holdback of this nature and would need to modify their systems and processes.
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4. Federal, State, and Local Government Cash Balances
- Federal, state, and local governments would need to modify their timelines/deadlines (*e.g.*, tax payment deadlines, fiscal year ends) in order to account for 5% of cash not being usable for 30 days.
  - Local and state statutes would require amendment to allow and/or account for a 5% hold on proceeds.
  - Absent changes to state and local law in many states, Money funds would not be a permitted investment if subject to a holdback requirement.

Application	Consequences
5. Municipal Bond Trustee Cash Management	<ul style="list-style-type: none"> <li>• On-time cash payments terms imbedded in contracts would need to be modified to account for the 30-day holdback of 5% of proceeds.</li> <li>• There may be implications for the credit quality and rating of bond issuances, as such ratings are tied to the soundness of the cash management program.</li> <li>• Accounting systems would require modification to account for and track the 5% holdback.</li> </ul>
6. Consumer Receivable Securitization Cash Processing	<ul style="list-style-type: none"> <li>• Daily liquidity is needed for cash held in connection with securitizations in order to timely meet payment obligations. A holdback would interfere with liquidity and payment timing.</li> </ul>
7. Escrow Processing	<ul style="list-style-type: none"> <li>• Systems that track the escrow would need to be modified to account for and track the 5% holdback.</li> <li>• Mortgage escrow accounts would only be 95% liquid or would be required to hold 105% of targeted payment amounts.</li> <li>• Uncertainty regarding available balances in omnibus/investment accounts would require daily tracking of holdback amounts.</li> <li>• Rolling up individual escrows into one omnibus account would pose additional challenges.</li> <li>• There would be a delay in the payment of 5% of all escrow balances.</li> <li>• Delay in payment from holdback would conflict with terms of current escrow agreements.</li> </ul>
8. 401(k) and 403(b) Benefit Plan Processing	<ul style="list-style-type: none"> <li>• To meet the need to segregate participant cash balances from those of the trustee, 401(k) and 403(b) plans would need to implement new recordkeeping requirements that account for the 5% holdback.</li> </ul>
9. Broker-Dealer Customer Cash Balances	<ul style="list-style-type: none"> <li>• There would be complications in the calculation of free credit balances held in a sweep account.</li> <li>• Broker-dealers would need to implement new recordkeeping requirements in order to incorporate the 5% holdback into processing and reconciliation systems.</li> <li>• If a holdback drives customer funds out of MMFs and sweep accounts, broker-dealers would have to increase the amount of the balance sheet liabilities they record for free credit balances.</li> <li>• There would be complications in the calculation of available cash to ensure the proper amount of margin is assessed for securities purchases in margin accounts.</li> <li>• Frequent MMF redemptions and associated holdbacks could restrict the amount of an investor's capital that is actually available for investment.</li> </ul>

Application	Consequences
10. Futures Dealer Customer Cash Balances	<ul style="list-style-type: none"> <li>• Futures market participants need to be able to quickly convert uninvested balances and other positions to cash; with a holdback, only 95% of uninvested balances have same day liquidity. This conflicts with CFTC Rule 1.25, which requires full daily redemption capability.</li> </ul>
11. Investment of Cash Collateral for Cleared and Uncleared Swap Transactions	<ul style="list-style-type: none"> <li>• Title VII of Dodd Frank Act imposes new regulations on swap transactions, including centralized clearing and collateralization requirements.</li> <li>• New CFTC Rule 22 specifies permitted investment of cash collateral for cleared swaps and proposed Rule 23 for uncleared swaps.</li> <li>• MMFs are among the narrow class of investments permitted for the cash collateral for swaps, which is subject to requirements of Rule 1.25.</li> <li>• A 5% holdback would conflict with the daily liquidity needs of the swaps market and would also be inconsistent with CFTC Rules 1.25 and 22 and proposed Rule 23.</li> </ul>
12. Cash Management / Sweep Accounts at Banks and Broker-Dealers	<ul style="list-style-type: none"> <li>• MMFs are a cornerstone of the financial transaction settlement process, but only 95% of the MMF balance is available for settlement on same-day basis.</li> <li>• There may be an increase in a bank's overdraft and NSF activity and downstream exception processing.</li> <li>• The debit card processor would not know if there are sufficient funds to cover customer activity, given the 5% holdback for each transaction.</li> <li>• Current automation between MMF accounting systems and broker-dealers' investment and cash management systems would be disrupted. Available balances could longer be independently calculated; companies would have to depend on counterparties to confirm balances.</li> </ul>
13. Portfolio Management	<ul style="list-style-type: none"> <li>• A portfolio that holds MMFs for fund liquidity would need to account for the 5% holdback in the event it needs to liquidate its MMF investments to raise cash.</li> </ul>
14. 529 Plans	<ul style="list-style-type: none"> <li>• In age-based programs, conservative models typically contain a high percentage of liquid assets as a student approaches the age requiring disbursements. A holdback would have implications for allocation models and asset availability.</li> <li>• Any "gross up" could have tax implications that should be considered by plan administrators and participants.</li> </ul>

**Application****Consequences**

## 15. MMF Portals

- *Applicable to capital requirement only.* Should there be a capital requirement providing for multiple funding options, portals may be required to modify systems/offering to accommodate additional information/data associated with the various fund products.