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Federated

WORLD-CLASS INVESTMENT MANAGER®

March 16, 2012

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:

We are writing to supplement the comments made in the letter of February 24, 2012, filed by Arnold & Porter LLP on behalf of Federated Investors, Inc. ("Federated"), regarding proposals to impose redemption restrictions on money market funds. In this letter, Federated would like: first, to expand upon the March 2, 2012, comment letter of DST Systems, Inc. regarding the insurmountable operational difficulties entailed in imposing a minimum balance on money market fund accounts; and second, to direct the Commission's attention to state laws and provisions of fund organizational documents that would prevent money market funds from imposing any form of redemption restriction. Federated believes that the facts reviewed in this letter, coupled with our earlier comments, demonstrate that any form of continual redemption restrictions would seriously impair the utility of money market funds and tremendously increase the cost of their operations.

A. Operational Impediments to Imposing a Minimum Balance Requirement

The Commission has not provided any details regarding how it would impose a required minimum balance on money market fund accounts. All that is clear from news reports is that the requirement would prevent shareholders from redeeming a specific percentage of their shares (a "Minimum Balance") for a specific period of time (a "Hold Period"). The fund would then allocate any losses to each shareholder's Minimum Balance before allocating losses to the remaining shares. For purposes of analysis, Federate will assume that that the Minimum Balance would be 5% and the Hold Period 30 days, so that the requirement would operate as follows:

1. <u>Calculation of the Minimum Balance</u>. A Minimum Balance for each shareholder's account would be calculated by multiplying the highest account balance during the preceding 30 days times 5%. This would leave a "Free Balance" in an account equal to the excess of the current balance over the Minimum Balance.

2. <u>Operation of the Minimum Balance</u>. Any redemption less than or equal to the Free Balance would be settled and paid regular way (*i.e.*, T or T+1 depending on

the fund's settlement procedures). Any redemption in excess of the Free Balance would be settled and paid at the end of 30 days.

3. Allocation of Losses to Minimum Balance. If the fund broke a dollar, it would reduce the price of shares representing the Minimum Balance before reducing the price of any Free Balance shares.[1] For example, if the fund suffered a 1% loss, it would reduce the price of Minimum Balance shares from $1 to 80 cents, while the price of Free Balance shares would remain $1. This would spread the loss equally among the fund's shareholders, regardless of how many shares they had redeemed in the preceding 30 days.

The first problem with such a Minimum Balance proposal is that it would require a vast amount of data. Calculating the Minimum Balances will require daily balance information for every account for every business day during the Hold Period, easily hundreds of millions of records. Funds could not avoid maintaining this amount of data because the Hold Period would be a rolling period. A fund could not, for example, simply compare the current balance to the previous highest balance, because the previous highest balance will eventually fall outside of the Hold Period, and the fund would then have to review every day in the Hold Period to determine which balanced was now the highest.

Another problem would be that fluctuations in the Minimum Balance would be highly disruptive to shareholders. For example, suppose a shareholder maintained a money market fund account with an average balance of $5000 for purposes of savings and paying major household expenses (*e.g.*, mortgage and car loan payments). If the shareholder sold her house and needed to invest $100,000 of proceeds from the sale until it was applied to the purchase of another home, she could not afford to invest the $100,000 in the money market fund account, because doing so would increase the required Minimum Balance to more than $5000. As the Minimum Balance would exceed the normal account balance for the following Hold Period, the shareholder would no longer have a sufficient Free Balance, once the $100,000 was withdrawn to pay be the new house, to cover monthly expenses.

Although basing Minimum Balances on average daily account balances, rather than the highest balance, might mitigate the effect of such temporary fluctuations, this approach would not reduce the data required for the calculation. Each day, the oldest balance would roll out of the average and a new balance would roll in. Any system would therefore need to keep track of every balance for every account during the entire Hold Period, so it eventually can be subtracted from the average. More significantly, basing the Minimum Balance on an average balance will not discourage runs. Redeeming the entire Free Balance would begin to reduce the average balance, and thus the Minimum Balance, immediately, so shareholders could still minimize their share of any losses by redeeming their entire Free Balance ahead of other shareholders.

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[1] Some have proposed first charging the full amount of any fund losses to shareholders who had redeemed during the Hold Period, thus penalizing their redemptions. In addition to contradicting the essential nature of a *mutual* fund, this would raise, as noted in our previous comment letter, serious issues for fiduciaries that would likely prevent them from using money market funds.

Imposition of a Minimum Balance might be easier from a data perspective if it was not required to be recalculated every business day. For example, funds might be required to calculate the Minimum Balances at the end of each month based on the average account balances for the month, and then use those Minimum Balances for the following month. Funds would still need a full month of daily balances for every account to calculate the Minimum Balances, however. As the primary cost of a Minimum Balance requirement will be creating the system for tracking the data and performing the calculations, running the system once a month rather than each day will probably not have a material impact on overall cost of a Minimum Balance requirement.

Another problem with a Minimum Balance requirement is that every intermediary who maintains money market fund accounts would have to undertake responsibility for implementing the requirement. Unlike banks accounts, most money market fund accounts are not maintained directly with the fund's transfer agent. Broker/dealers, banks, trust companies, retirement plan administrators and other intermediaries may establish "omnibus accounts" with a fund, in which they aggregate shares held on behalf of their underlying clients or beneficiaries. The allocation of shares and trades in an omnibus account among underlying accountholders is completely opaque to the fund. Funds cannot prevent the establishment of omnibus accounts, which are the standard means by which most U.S. investors hold all their securities (not just shares of money market funds). Consequently, money market fund would have to rely on these intermediaries to implement a Minimum Balance requirement.

The failure of intermediaries to impose the required Minimum Balance would subvert the primary purpose of the requirement—to reduce the incentive to attempt to avoid losses by redeeming shares. If accounts underlying an omnibus account were not subject to a Minimum Balance, the underlying shareholders would have an added incentive to redeem in order to avoid the being trapped by the intermediary's Minimum Balance. For example, if an omnibus account held 100,000 shares of a money market fund, the Minimum Balance for the omnibus account would be 5,000 shares and the Free Balance would be 95,000 shares. If the shares were divided equally among twenty underlying accounts, 19 of the accountholders could redeem their entire balance without risk of loss, but the one remaining shareholder could not redeem any shares for 30 days. The heightened risk of being the last shareholder stuck in an omnibus account would only encourage more rapid redemptions at the first sign that a fund might be in trouble.

The aggregate cost of a Minimum Balance requirement for intermediaries will be staggering. As previously noted, the principle costs of implementing a Minimum Balance requirement will be the costs of creating systems to calculate and implement the Minimum Balance and the costs of gathering and maintaining the required data. The systems costs will be directly proportional to the number of intermediaries maintaining omnibus accounts (and sub-omnibus accounts). The data costs will be directly proportional to the number of accounts (including underlying accounts) and the number of days in the Hold Period. Given that there are tens of thousands of intermediaries and tens of millions of accounts, even relatively modest systems and operational costs can amount to billions of dollars.

Someone might suppose that it would reduce the systems costs if all intermediaries transmitted underlying account balances to the transfer agent each day, so that the transfer agent could calculate and transmit back to the intermediaries the Minimum Balances for their accounts.

Any savings for the intermediaries would be offset, however, by the costs of developing and maintaining the system for transmitting the data to and from the intermediaries. Intermediaries also would still bear the full cost of gathering data and implementing the Minimum Balance on each underlying account, and transfer agents would still bear the full cost of maintaining the data for the entire Hold Period. Both groups would incur additional costs in reconciling data and monitoring the system. Thus, centralizing the process would not reduce the cost of the proposal.

Most importantly, imposition of unique and costly Minimum Balance requirements will deter many intermediaries from offering money market funds altogether. Unless the revenue earned by an intermediary from a money market fund share omnibus account exceeds the cost of imposing a Minimum Balance on the underlying accounts, the intermediary will stop offering money market funds to its clients. For example, it may not be cost effective for an administrator to invest in the system necessary to impose Minimum Account balances on 401(k) plan accounts, which may cause the plans to replace money market funds with stable-value collective funds, which would not be subject to any redemption restrictions. There is no reason to suppose that such an arbitrary limitation of investment options would be beneficial to investors.

B. State Law Impediments to Redemption Restrictions

Federated does not believe that its second concern, namely, the relationship of a holdback to the shareholders' rights under state corporate and business trust laws, has been address by any previous commenters. As the Commission is aware, money market funds are in the first instance creatures of state law, organized as trusts or corporations, and then registered under the Investment Company Act of 1940 (the "1940 Act") and the Securities Act of 1933. Such state laws govern, *inter alia*, shareholder rights, preferences, dividends and distributions, and will, as a matter of corporate law, determine the extent to which a money market fund may charge losses or expenses against amounts held back from redemptions. Such laws may even limit the fund's ability to hold back anything in the first instance. As the Commission does not have any authority to modify state laws or fund organizational documents, it cannot resolve these issues through regulations. Although some of the limitations might be addressed with shareholder consent, there is no reason to suppose that shareholders will be any more willing to consent to these changes than they would be willing to continue to use the funds after the redemption requirements were imposed.

As noted in the preceding section, the Commission has not provided details regarding the redemption restrictions under consideration. As an alternative to a Minimum Balance requirement, another possible restriction would be to allow money market fund shareholders to redeem any amount of shares, but require the fund to withhold a specified percentage of every redemption for the Hold Period (a "Redemption Holdback"). To illustrate, we will assume again that 5% is required to be held back for a period of 30 days. If a shareholder had an account balance of $1,000, a Redemption Holdback would permit the shareholder to redeem any or all of the balance at any time. The fund would withhold, however, 5% of any redemption and pay this amount 30 days later. Hence, if the shareholder redeemed $500, he would receive $475 on a same-day basis and $25 in 30 days. In contrast, under a Minimum Balance requirement, if the shareholder redeemed $500, the redemption would be paid on a same-day basis, and the Minimum Balance would be reduced 30 days later from $50 to $25.

Merely delaying redemptions payments will not accomplish anything, however, other than making the redemption process more complex and burdensome. The point of a holdback proposal would be to use amounts withheld to cover losses and/or expenses incurred by the fund during the Hold Period. This would, in theory, reduce the motivation to redeem by preventing shareholders from avoiding losses by redeeming their shares before a fund can break a dollar. Thus, the effectiveness of any holdback proposal depends on the funds' ability to use the amounts withheld to pass on losses and/or expenses to their redeeming shareholders.

The problem is that most state laws and/or fund organizational documents do not permit funds to treat shares held as a Minimum Balance differently from other shares or to treat redeeming shareholders differently from remaining shareholders. Such laws and documents require losses (as well as gains and dividends) to be allocated *equally* among the funds *outstanding* shares. This prevents funds from subordinating shares representing a Minimum Balance to other outstanding shares of the same class or series. Furthermore, once redeemed, shares are no longer subject to the fund's losses (just as they are no longer entitled to dividends or gains), which prevents a fund from reducing a Redemption Holdback for losses incurred during the holdback period.

1. Treatment of Minimum Balances under State Laws

Most states would not permit a fund organized in the state to freely allocate losses to some shares and not to others. For example, Section 2-105(a) of the Maryland General Corporate Law (under which many money market funds are organized) permits:

> A corporation [to] provide by its charter:
>
> (5) That any specified class or series of stock is preferred over another class or series as to its distributive share of the assets on voluntary or involuntary liquidation of the corporation and the amount of the preference ….

Maryland law only permits a separate series or class of stock to be preferred to another series or class—it does not permit the preference or subordination of shares within a series or class.

Accordingly, a money market fund organized in Maryland must allocate losses equally to all outstanding shares within a class or series, not just to shares representing Minimum Balances. This means that the fund in our example cannot simply reduce the price of the Minimum Balance shares from $1 to 80 cents while leaving the other shares valued at $1. The fund must instead value all of the shares at 99 cents, which will result in shareholders who redeemed before the price decrease reducing their share of losses. This would not lessen a shareholder's incentive to redeem to any significant extent.

Money market funds organized as Delaware statutory trusts are subject to similar limitations. Section 3806(b) of the Delaware law governing statutory trusts permits:

> (b) A governing instrument [to] contain any provision relating to … the rights, duties and obligations of the trustees, beneficial owners and other persons, which

> is not contrary to any provision or requirement of this subchapter and, without limitation:
>
> (1) May provide for classes, groups or series of trustees or beneficial owners, or classes, groups or series of beneficial interests, having such relative rights, powers and duties as the governing instrument may provide, and may make provision for the future creation in the manner provided in the governing instrument of additional classes, groups or series of trustees, beneficial owners or beneficial interests, having such relative rights, powers and duties as may from time to time be established, *including rights, powers and duties senior or subordinate to existing classes, groups or series* of trustees, beneficial owners or beneficial interests …. [Added emphasis]

As with Maryland corporate law, the Delaware law requires establishment of a separate class, group or series of shares of beneficial interest in order to subordinate some shares to others. Allocation of fund losses to shares representing a Minimum Balance is a form of subordination, and therefore could not be accomplished if the Minimum Balance shares are the same class, group or series as other shares in the account.

Even if state law is silent on the issue, a fund's organizational documents are likely to require equal treatment of all shares within a given class or series. For example, Federated's standard Declaration of Trust for a Massachusetts business trust provides that:

> Unless the Trustees have authorized the issuance of Shares of a Series in two or more Classes, each Share of a Series shall represent an equal proportionate interest in the assets and liabilities and the income and the expenses of the Series with each other Share of the same Series, *none having priority or preference over another*. If the Trustees have authorized the issuance of Shares of a Series in two or more Classes, then the Classes may have such variations as to dividend, redemption, and voting rights, net asset values, expenses borne by the Classes, and other matters as the Trustees have authorized provided that each Share of a Class shall represent an equal proportionate interest in the assets and liabilities and the income and the expenses of the Class with each other Share of the same Class, *none having priority or preference over another*. [Added emphasis]

Federated has identified money market funds managed by other companies with similar provisions, so this limitation is not unique to Federated's funds and is very likely wide-spread.

Such laws and provisions requiring equal treatment of shares within the same class, group or series are not surprising. First, shares must be fungible in order to be traded as negotiable instruments. Unless senior and subordinated shares are separately designated (*e.g.*, as separate classes), prospective investors cannot tell what priorities their shares will have and cannot tell whether they are buying or selling subordinated shares. This is one reason that state laws require designation of preferred and subordinated shares as separate classes.

Second, Section 18(f) of the 1940 Act prohibits mutual funds from issuing senior securities, except for separate classes or series "preferred over all other classes or series in respect of assets specifically allocated to that class or series" (*i.e.*, separate series of funds) Although the Commission has promulgated Rules 18f-2 and 18f-3 to permit mutual funds to issue separate series and classes of shares, neither rule permits funds to allocate portfolio losses to one share ahead of another share of the same class or series. To assure compliance with these regulations, organizational documents that authorize issuance of classes or series of shares typically provide that none of the shares within a class or series will have any priority or preference over other shares in the class or series.

Someone might suggest that a Minimum Balance requirement could comply with these state law limitations if it required money market funds (1) to issue two classes[2] of shares, one subordinated to the other, and (2) to count only the subordinated shares towards the Minimum Balance. This would greatly complicate the capital structure of money market funds (contrary to the purpose of Section 18) and would pose enormous operational problems. First, it would double the number of classes of money market fund shares and the costs associated with maintaining classes of shares. Second, someone would need to redeem subordinated shares or convert them into senior shares whenever a redemption reduced the required Minimum Balance. While, in theory, shareholders might do this (for example, by entering an order to redeem a proportionate number of subordinated shares with each redemption order for senior shares), funds and intermediaries are likely to offer automated systems for keeping the subordinated shares in each account at the required Minimum Balance. This will add system development costs, double the transaction cost of each purchase and redemption (due to the need to add or redeem subordinated shares to maintain the required Minimum Balance) and increase the cost of maintaining, reconciling, auditing and reporting share balances to shareholders and in financial statements. Finally, as noted in the first section of this letter, any form of Minimum Balance requirement will require transfer agents and intermediaries to develop systems to calculate the Minimum Balances and maintain historical balance information for every account, further adding to the costs of this approach.

2. Treatment of Redemption Holdbacks under State Laws

State law problems would be more acute for a Redemption Holdback. Under state laws, the right to redeem shares must be established in the fund's organizational documents. Thus, Federated's standard Declaration of Trust for a Massachusetts business trust provides that:

> In case any Shareholder of record of any Series or Class at any time desires to dispose of Shares of such Series or Class recorded in his name, he may deposit a written request (or such other form of request as the Trustees may from time to time authorize) requesting that the Trust purchase his Shares, together with such other instruments or authorizations to effect the transfer as the Trustees may from time to time require, at the office of the transfer agent, or as otherwise provided by the Trustees and the Trust shall purchase his Shares out of assets belonging to such Series or Class. *The purchase price shall be the net asset value of his shares*

[2] Some money market funds may not be able to comply with even this requirement, insofar as their organizational documents may not authorize the issuance of multiple classes of shares.

> *reduced by any redemption charge or deferred sales charge* as the Trustees from time to time may determine. [Added emphasis]

The provisions of Federated's standard Delaware Declaration of Trust are the same:

> The Trust shall purchase such Shares as are offered by any Shareholder for redemption, upon the presentation of a proper instrument of transfer together with a request directed to the Trust or a Person designated by the Trust that the Trust purchase such Shares or in accordance with such other procedures for redemption as the Board of Trustees may from time to time authorize; and *the Trust will pay therefor the net asset value thereof*, in accordance with the By-Laws and applicable law. The payment of redemption proceeds may be reduced by any applicable sales charges or fees described in the Prospectus. Payment for said Shares shall be made by the Trust to the Shareholder within seven days after the date on which the request is received in proper form. [Added emphasis]

In addition, Federated's standard Maryland Articles of Incorporation provides:

> To the extent the Corporation has funds or property legally available therefor, each shareholder shall have the right at such times as may be permitted by the Corporation, but no less frequently than as required under the 1940 Act, to require the Corporation to redeem all or any part of its shares *at a redemption price equal to the net asset value per share next determined after the shares are tendered for redemption, less any applicable redemption fee or deferred and/or contingent deferred sales charge* as determined by the Board of Directors. [Added emphasis]

Comparable provisions will be found in the organizational documents of any mutual fund offering redeemable shares, because the 1940 Act defines a "redeemable security" as a security "under the terms of which the holder, upon its presentation to the issuer or to a person designated by the issuer, is entitled (whether absolutely or only out of surplus) to receive approximately his proportionate share of the issuer's current net assets, or the cash equivalent thereof." Fund organizational documents mirror this definition by requiring the fund to pay the *entire* current net asset value for any shares redeemed. Their organizational documents do not allow the fund to holdback any portion of the redemption price for later payment. The only permitted exceptions are for redemptions fees and deferred sales charges. Insofar as these provisions were intended to comply with the requirements of the 1940 Act, they should be construed consistently with the construction of the 1940 Act at the time the organization documents were adopted. Thus, it is unlikely that Redemption Holdbacks would qualify as either redemptions fees, which (as currently defined by the Commission in Rule 22c-2 and previously defined in Rule 11a-3) must be retained by the fund and not returned to the shareholder, or deferred sales charges, which (as defined in Rule 11a-3) must represent sales or promotional expenses.

As importantly, even if a fund found some authority to delay a portion of a redemption payment, any reduction in the final payment would contravene the requirement that the shareholder receive the *current net asset value* of the redeemed shares. Once the fund determines the net asset value for purpose of paying the unrestricted portion of the redemption (*e.g.*, 95 cents per share), the fund must eventually pay the remaining net asset value of the shares (*e.g.*, the balance of 5 cents a share). Fund organizational documents do not contain provisions for recalculating the net asset value. The means that funds with these forms of organizational documents could not reduce a Redemption Holdback by the amount of losses or expenses incurred during the Hold Period.

The Delaware declaration of trust contains another provision that would prevent the imposition of a Redemption Holdback, namely the requirement that the fund pay redemptions within seven days. This reflects Section 22(e)[3] of the 1940 Act, which prohibits a fund from delaying payment of a redemption for more than seven days in the absence of an exemption or order from the Commission. The Delaware declaration of trust does not provide any exceptions to the seven-day payment requirement, however, so a Delaware fund could not hold any portion of a redemption back for more than seven days.

Someone may suggest that money market funds could avoid these limitations by amending their organizational documents. Federated's experience demonstrates that this would be, at best, an expensive undertaking and perhaps a futile one. In 2008, Federated solicited the shareholders of ten money market funds to change a fundamental investment limitation. Due to a lack of a quorum, Federated was required to adjourn the shareholder meetings seven times. One of the funds never obtained a quorum, and the proposal lapsed. Federated's total out-of-pocket costs for the solicitations approximated $3.3 million. The effort likely cost Federated significant goodwill, as many shareholders and their advisors did not appreciate repeated calls from the proxy solicitation firms urging them to vote.

An attempt to amend a fund's organizational documents, particularly to remove provisions that shareholders would reasonably consider protective of their interests, would probably cost more and would be less likely to succeed. Based on our recent experience, when you look across all money market fund sponsors, assuming similar states of incorporation and organizational documents, expenditures to conduct shareholder meetings and solicit proxies would run to the hundreds of millions of dollars (and the success of those proxies are not by any means assured). Under normal market conditions shareholders might be expected to bear the cost of such a proxy, but in the current yield environment such cost would likely be borne by advisers who are also waiving substantial fees. Such an expense would likely trigger further consolidation, with smaller advisers and those with less access to capital leaving the business.

The Commission has the data necessary to better evaluate the potential costs of such amendments, insofar as organizational documents are required exhibits to fund registration statements. The staff could review these documents for provisions that would prevent adoption of a Redemption Holdback, and then multiply the result by a reasonable estimate of the cost of preparing and soliciting proxies. Estimating the impact of shareholders failing to approve the

[3] Federated does not see how the Commission proposes to square a continual holdback requirement with Section 22(e). The section only permits the Commission to delay redemptions for more than seven days in the event of an "emergency" or by a specific order. Although the Commission can define what constitutes an emergency, we do not see how anyone could contend in good faith that an emergency can exist continuously regardless of actual market conditions.

amendments would be more difficult, however. Would funds that could not impose a Redemption Holdback be required to merge or liquidate? Would they be required to move to a floating NAV, thereby frustrating the fund's investment objective and the expectations of shareholders? If so, how will the Commission gauge the adverse impact of the resulting increase in fund concentration and market disruptions?

C. Conclusion

Federated hopes the Commission appreciates and pays due regard to the ever mounting evidence against imposition of redemption restrictions on money market fund shares. Aside from the enormous operational challenges and associated costs, every study of which we are aware shows that shareholders will not accept such restrictions and are likely to respond to the restrictions by withdrawing from money market funds. This is because any restriction that might possibly deter redemptions from money market funds will also certainly deter the use of the funds. Likewise, any restrictions that might be acceptable to large numbers of shareholders are unlikely to have much effect on their redemption activity.

Redemption restrictions are therefore unlikely to produce any net benefits to shareholders or to financial markets generally. They will certainly, however, entail tremendous costs—both initially and on an ongoing basis. Finally, the Commission cannot be certain that, regardless of how much sponsors and funds spend, state laws and fund organizational documents will permit funds to implement redemption restrictions. For these reasons, Federated does not believe that the Commission will gain anything by proposing any form of general redemptions restrictions on money market fund shares.

Yours very truly,

/s/ John W. McGonigle
Vice Chairman

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, Deputy Director, Division of Investment Management