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Federated
WORLD-CLASS INVESTMENT MANAGER®

January 7, 2011

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:

This letter presents the comments of Federated Investors, Inc. and its subsidiaries ("Federated") on the recent release by the Securities and Exchange Commission ("SEC," or "Commission") seeking comments on the report presenting the results of the President's Working Group on Financial Markets (the "PWG") study of possible money market fund reforms (the "PWG Report").[1] Federated is one of the largest investment management firms in the United States, managing $341.3 billion in assets as of September 30, 2010. With 134 funds and a variety of separately managed account options, Federated provides comprehensive investment management to approximately 5,200 institutions and intermediaries including corporations, government entities, insurance companies, foundations and endowments, banks and broker-dealers. As of September 30, 2010, Federated managed U.S. registered money market funds with assets of over $230 billion, making it the third largest manager of U.S. money market funds.

Federated appreciates the effort made in the PWG Report to provide a balanced assessment of the proposed reforms. Anyone reading the PWG Report should agree that there is no easy way of minimizing either the risk or impact of wide-spread redemptions from money market funds. This does not mean, however, that money market funds should be eliminated, which would be the result of several of the proposed reforms. In light of the Commission's recent efforts to reduce the risks of money market funds, Federated believes that it would be more appropriate to focus on those reforms that may reduce the impact of large scale redemptions, such as an emergency liquidity facility. Federated therefore fully endorses the comments made by the Investment Company Institute (the "ICI") regarding the PWG Report. Federated has been an active participant in the ICI's Money Market Working Group and has contributed to its analysis of the reforms proposed in the PWG Report.

Federated also believes that the Commission should not undertake any significant reforms until sufficient time has passed to evaluate the impact of the money market fund reforms adopted last year, the various market reforms required by the Dodd-Frank Wall Street Reform

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[1] The PWG Report was published for comment in Release No. IC-29497, President's Working Group Report on Money Market Funds (Nov. 3, 2010), available at http://www.sec.gov/rules/other/2010/ic-29497.pdf.

and Consumer Protection Act (the "Dodd-Frank Act") and other reform efforts to strengthen and stabilize the capital markets. The financial crisis did not originate with money market funds, and a large number of financial institutes either failed or were rescued (*e.g.*, collateralized debt obligations, structured investment vehicles, auction rate securities, mono-line bond insurers, Bear Stearns, Fannie Mae and Freddie Mac, Merrill Lynch, AIG and numerous commercial banks) before Lehman Brothers' bankruptcy caused the Reserve Primary Fund to break a dollar. After this event, it required far less assistance to shore up the money market funds than the federal government expended on investment and commercial banks, automobile manufacturers or any other industry that received support during the crisis. Every instrument sold by money market funds into the Federal Reserve's liquidity facilities for commercial paper and asset-backed securities repaid its full principal amount when due, with interest. The Treasury also made money on the temporary, limited insurance program established for money market funds, without, in contrast to FDIC insurance, having to pay any claims. In short, unlike many other financial institutions, money market funds were not the source of any "toxic" assets that required a taxpayer funded "bailout."

These facts are a testament to the intrinsic resiliency of money market funds. Since the crisis, the Commission has taken far-reaching steps to further strengthen money market funds, and should wait until it can assess their full impact before proposing additional reforms.

Federated is writing separately to supplement the points made in the ICI's comment letter. Specifically, we want to (i) state the case for the importance of money market funds to the U.S. capital markets and economy, (ii) elaborate on the serious drawbacks inherent in forcing money market funds to "float" their NAVs and (iii) urge the Commission to shift its attention from reducing the risk of a money market fund "breaking a dollar" to the best means of limiting the consequences of a fund breaking a dollar to its investors, other money market funds and to the capital markets generally.

I. ELIMINATION OF MONEY MARKET FUNDS WOULD WEAKEN THE U.S. FINANCIAL SYSTEM WITHOUT REDUCING SYSTEMIC RISKS

As a preliminary matter, we wanted to note that the PWG Report appears to assume that a mutual fund could have a "floating NAV" and still be considered a money market fund. In Federated's view, this would be a contradiction in terms. From the investing public's perspective, a money market fund is a mutual fund that maintains a stable share price during normal market conditions. Investors do not consider mutual funds that offer shares with fluctuating prices to be money market funds, nor do they consider stable value investments offered by entities other than mutual funds (such as banks) to be money market funds. In the United States,[2] there is simply no such thing as a money market fund with a floating NAV.

[2] We realize that European regulations explicitly allow both stable value and fluctuating value funds to refer to themselves as "money market funds." CESR 10-049, "CESR's Guidelines on a Common Definition of European Money Market Funds" (May 19, 2010). Federated operates several "short-term" money market funds organized in Ireland and sold in Europe. In our experience, investors in these funds either differentiate between "real" money market funds (i.e., short-term funds) and "so-called" money market funds, or expect the share price to remain stable regardless of the distinctions drawn in the regulations.

With this in mind, it becomes apparent that the implementation of two of the proposed reforms (requiring money market funds either to have floating NAVs or to become limited purpose banks) would entail the elimination of money market funds. Another reform (allowing only "retail" money market funds to continue to maintain a stable price) would result in the elimination of "institutional" money market funds. Federated will therefore address its responses to all three of these proposals together.

Money market funds have attracted nearly $3 trillion from investors because of the benefits they provide to their shareholders and to the entities they help to finance. The collateral effects of these benefits are improved capital formation and more efficient capital markets in the U.S., with a corresponding increase in the size of the U.S. economy. Any consideration of proposals to eliminate money market funds that fails to take these benefits into account would be incomplete. In addition, while the PWG Report acknowledges the serious drawbacks of eliminating money market funds, it underestimates the significance and extent of these drawbacks.

A. Benefits of Money Market Funds

Having just enjoyed the season for *It's a Wonderful Life*, it seems fitting to contemplate what the U.S. financial system would be like if money market funds had never existed. Without an angel to guide us, we can only estimate the extent to which money market funds have contributed to the efficiency of the capital markets and consequently to the growth of the U.S. economy. However, the following contributions made by money market funds cannot be seriously disputed:

- Money market funds have increased the returns to retail cash investors by at least $225 billion since 1985, when the ICI first started tracking money market fund assets and yields. This estimate is based on the additional yield paid by the average retail money market fund[3] over the rate paid on the average money market deposit account by banks, times the assets held in such money market funds. It actually underestimates the contributions of retail money market funds, because (a) without competition from money market funds, interest rates on money management accounts would have been lower and (b) not all retail cash investors had sufficient balances to qualify for interest bearing bank accounts or for accounts paying the interest rate used in our calculations.

- It is reasonable to assume that money market funds have had a comparable positive effect on institutional cash investors, although this is more difficult to quantify because some (although by no means all) institutional investors have access to cash investments other than money market deposit accounts. The fact that so many institutions have used money market funds so consistently demonstrates, however, that the returns provided by money market funds exceeded those provided by any of these alterna-

[3] The ICI did not track assets separately for retail and institution money market funds until 1996. In 1996, over 63% of money market fund assets were held in retail funds. For the period from 1985 through 1995, we made the conservative assumption that 70% of money market fund assets were held in retail funds.

tives. This is not surprising—direct investment in money market instruments (other than bank instruments) requires personnel to analyze, select and trade the instruments, custodians to hold the instruments and a substantial amount of bookkeeping. Furthermore, institutions that are not "qualified institutional buyers" cannot participate in the market for Rule 144A securities, which typically provide better returns than other types of money market instruments. Also, it is likely that many institutional investors lack the operational infrastructure and expertise to participate in the repo markets. Finally, few institutions manage cash positions large enough to obtain the level of diversification or the same price and quality of execution as a professional manager with tens, if not hundreds, of billions of dollars of cash assets under management. Therefore, it is reasonable to assume that the total benefit of money market funds to investors, both retail and institutional, since 1985 was on the order of $400 to $500 billion.

- Money market funds have lowered the average cost of funding for companies, states, municipalities and even the federal government. As the ICI comment letter indicates, money market funds hold nearly 40% of the commercial paper outstanding in the U.S. Moreover, money market funds have been instrumental in the growth of the commercial paper market over the last forty years. This impact is also hard to quantify, but here again, companies would not issue commercial paper if it were not advantageous relative to bank loans or other funding sources.

  Money market funds would seem to have had an even bigger impact on state and municipal issuers. Prior to the advent of money market funds, these issuers typically obtained short-term financing through banks at less advantageous rates. Institutional demand for short-term tax exempt obligations is limited[4] and retail distribution is prohibitively expensive. We estimate that money market funds currently hold 85% of the outstanding short-term tax-exempt notes.

  Money market funds historically provide between a quarter to a third of the funding available in the tri-party repo market.[5] Repo is used primarily to finance securities held in inventory by dealers, and thereby contributes directly to the efficiency of the capital markets. In particular, repo contributes to the unparalleled efficiency and liquidity of the market for U.S. Treasury and agency securities, which significantly reduces the borrowing costs for federal programs. In addition,

[4] Corporations cannot deduct expenses incurred to carry tax exempt obligations beyond a 1% "de minimis" amount. Historically, those corporations that have invested directly in tax exempt obligations have not exceeded this amount, so they could not replace the funding provided by tax exempt money market funds. Other institutional investors (such a pensions, charities and foreign institutions) are exempt from taxation and do not invest in tax-exempt obligations. Insurance companies typically invest in longer term tax exempt obligations.

[5] New York Federal Reserve Staff Report No. 477, "The Tri-party Repo Market before the 2010 Reforms," (Nov. 2010).

as shown in the ICI's comment letter, money market funds provide nearly half of the short-term funding to federal agencies.

- Historically, money market funds have been a gateway to other mutual funds. Most individuals save money before they begin to invest. Money market funds allow individuals to use a mutual fund as a savings vehicle, by providing ready liquidity and a stable price under most market conditions. Individuals who invest in money market funds are exposed to other mutual funds offered by the adviser, and may become more comfortable moving to these funds once they have achieved their targeted savings. They may also be more inclined to invest directly in the stock market than individuals who never venture beyond their bank account and certificates of deposit. In addition, individuals investing in money market funds gain access to the general investor education materials provided by the funds' investment advisers.

All of these factors have contributed significantly to capital formation in the U.S. Improved returns for investors encourage savings, and lower rates for borrowers encourage capital expenditures. Dynamic, efficient and transparent markets improve the allocation of capital and increase economic growth. In light of all this, it seems certain that money market funds have contributed, and continue to contribute, in a meaningful way to the growth of the U.S. economy.

B. Adverse Consequences of Eliminating Money Market Funds

Federated appreciates the balanced approach taken by the PWG Report in presenting the reform alternatives, particularly by identifying the major concerns associated with each proposal. With respect to the proposal to require money market funds to float their NAVs, however, Federated believes that the PWG Report underestimates the full extent of these problems. The following elaborates on the concerns identified in the PWG Report.

1. "A change [to a floating NAV] might reduce investor demand for money market funds and thus diminish their capacity to supply credit to businesses, financial institutions, state and local governments, and other borrowers who obtain financing in short-term debt markets."

Contrary to the PWG Report (p. 21), Federated believes that there is ample "direct evidence of the likely effect of a floating NAV on the demand for [money market funds] …." From January 2009 (which was the high point for money market fund assets) through October 2010, investors redeemed nearly $1.1 trillion from money market funds.[6] The primary reason for these redemptions is obvious—this year the average money market fund will return only 4 basis points.[7]

[6] Investment Company Institute Money Market Fund Assets Historical Data (Dec. 9, 2010), available at http://www.ici.org/info/mm_data_2010.xls.

[7] Money Fund Intelligence at 2 (Dec. 2010).

At this time, when compared to other mutual funds, money market funds have nothing to offer investors other than a stable NAV. There is no more plausible explanation for why investors maintain over $2.8 trillion in money market funds than the paramount importance of a stable NAV to these investors. It is unlikely that investors would continue to invest these cash balances in a mutual fund that did not offer a stable NAV. This means that nearly all of the $2.8 trillion currently invested in money market funds would move to other stable value investments if money market funds were eliminated. In other words, requiring money market funds to float their NAVs would substantially eliminate the current demand for the funds.

It may be suggested that investors who have been redeeming their shares since January 2009 have shown a willingness to take market risks and, under normal market conditions, would continue to invest in money market funds with floating NAVs. The data suggests, however, that much of this money was moved to bank deposits. A survey by the Association of Financial Professions shows that bank deposits and money market funds have traded places over the last two years. In 2008, surveyed professionals allocated 39.4% of their short-term investments to money market funds and 25% to bank deposits; in the 2010 survey, bank deposits garnered 41.5% of short-term investments as compared to 25.1% for money market funds.[8] This may account for some of the $668 billion increase in commercial bank deposits from January 2009 through October 2010.[9] Therefore, it would probably be optimistic to assume that, under normal market conditions, demand for money market funds without stable NAVs would reach even $500 billion, which is less than 15% of the assets held in money market funds at the beginning of 2009.

In addition to this quantitative data, the comment letters from investors or groups representing investors that the Commission received in response to its money market fund reform proposal, which universally opposed floating funds' NAVs, clearly testify to the overriding importance of a stable NAV.

2. *"Elimination of money market funds' stable NAVs may cause investors to shift assets to stable NAV substitutes that are vulnerable to runs but subject to less regulation than money market funds. … Elimination of money market funds' stable NAVs may also prompt some investors—particularly retail investors—to shift assets from money market funds to banks."*

The foregoing analysis strongly indicates that the second element of this concern—the shift of assets from money market funds to banks—would be a likely result of the elimination of money market funds. Moreover, the shift in assets could easily exceed a trillion dollars. The PWG Report (p. 34) notes that this could require banks to raise tens of billions of dollars of additional equity. This would be in addition to the capital required to comply with the new requirements of Basel III. To attract this capital, banks will need to increase their earnings, most

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[8] 2008 AFP Liquidity Survey at 15 (June 2008), http://www.afponline.org/pub/pdf/2008_AFP_Liquidity_Survey.pdf, and 2010 AFP Liquidity Survey at 15 (June 2010), http://www.afponline.org/pub/pdf/2010_AFP_Liquidity_Survey.pdf.

[9] Federal Reserve Report H8 Assets and Liabilities of Commercial Banks in the United States (Dec. 20, 2010), available at https://www.federalreserve.gov/releases/H8/default.htm.

likely by increasing the interest charged for borrowings and reducing the interest paid on deposits. Thus, the shift to banks would create a drag on U.S. capital formation and economic growth.

The shift also would increase the concentration of assets in bank holding companies classified as systemically significant by the Dodd-Frank Act. According to Crane Data, as of November 30, 2010, JP Morgan Chase, The Bank of New York Mellon, Wells Fargo, State Street Bank, Northern Trust and Bank of America sponsored money market funds with assets of $800 billion. In Federated's experience, which includes administration of bank sponsored money market funds, the bulk of these assets are generated from the affiliated bank complex and, if not held in their money market funds, would be deposited in other bank instruments or products. Therefore, the shift in assets would further increase the significance of institutions that already have been deemed to pose systemic risks to the U.S. financial system.

With respect to the potential shift to unregulated funds, the PWG Report (p. 35) proposes to address this through legislation to "Enhance Constraints on Unregulated [Money Market Fund] Substitutes." The only concrete proposal in the report is to prohibit Section 3(c)(1) and 3(c)(7) funds from seeking to maintain a stable NAV. Such a prohibition would not prevent, however, institutional investors from shifting assets outside the U.S. and investing in offshore stable value funds. In any event, this proposed reform would not be necessary if regulated money market funds are not eliminated.

3. *"Money market funds' transition from stable to floating NAVs might itself be systemically risky."*

The PWG Report (p. 22) suggests this can be avoided through "careful design of the conversion process." This is an overly optimistic assessment. The problem with the conversion process is that while trying to prevent future runs, it would produce market conditions that could prompt shareholders to run from money market funds before the conversion takes effect. Money market fund shareholders will face an immediate prospect that their funds could "break a dollar" after they convert to a floating NAV, so they are motivated to redeem before the conversion date. Responsible managers will raise liquidity to meet these redemptions, either by selling holdings or refusing to roll investments. Selling pressure would lower prices and not rolling investments would cut off funding to issuers, which will increase the risk that converted funds will break a dollar. This would encourage more redemptions from the funds and would lead to the cycle repeating itself.

Converting funds in phases (which would be one way to design the process) will just make the disruption to the capital markets more protracted. Shareholders will still have the same incentive to redeem before their fund converts, so fund managers will have the same motivation to increase liquidity by selling and not buying. Knowledge that converting funds will be withdrawing liquidity from the capital markets will deter non-converting funds and other institutions from buying money market instruments. Moreover, cash from converting funds may be shifted to non-converting funds, making each phase of the conversion process larger and more disruptive. In summary, Federated does not see how a conversion process can be designed to avoid creating its own systemic risk.

4. *"Risk management practices in a floating NAV money market fund industry might deteriorate without the discipline required to maintain a $1 share price."*

The PWG Report highlights how a floating NAV might lead to greater risks in money market funds, but fails to acknowledge the risk implications of the probable shift from money market funds to other investments. Assuming for this point that the Commission could eliminate unregulated money market fund substitutes, investors who are unwilling to hold their cash in a fund with a floating NAV will either move their cash to banks or invest directly in commercial paper and other money market instruments. Neither banks nor institutions managing their own cash are likely to manage risks with the same discipline as money market funds.

Regulations allow banks to take greater risks than money market funds, and they must do so in order to attract the capital necessary for their growth. Banks can lend money for any term to any borrower they deem creditworthy, and may engage in a broad array of related businesses posing various degrees of risk. Thus, it is certain that money shifted from money market funds to banks will be invested for longer terms, and also may be invested in obligations with lower credit quality, than are held within current money market fund portfolios.[10] This would increase the overall level of risk in the financial system.

With respect to other institutional investors, they cannot afford to dedicate the same personnel and resources to cash management as do money market funds. Institutional investors are more likely to rely on ratings rather than perform their own credit analysis. In addition, they generally cannot attain the same degree of diversification through direct investment as they do through money market funds. Thus, a complete disintermediation of the institutional cash market through the elimination of money market funds would also result in an increase in the overall level of risk in the financial system.

5. *"The final concern is that a floating NAV that accomplishes its proponents' objectives of reducing systemic risks may be difficult to implement."*

In this concern, the PWG Report acknowledges that reforms which would require floating NAVs in theory but which would not change investors' expectations of a stable share price will not reduce systemic risks. Investors who expect a stable price will still try to redeem when they perceive a significant risk that the price will fall below its normal level or suffer further declines. If reforms do not change this behavior, then they will not accomplish their objective.

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[10] The PWG may intend to limit the proposed "special purpose banks" to the same degree of risks as money market funds, although the description in the PWG Report is too cursory to tell. If this is the case, and the aim is to create banks that offer deposits with interest at rates which are more competitive with money market funds, then Federated does not see any reason to tie the introduction of these banks to the elimination of money market funds. If banking regulators think it prudent to relax the capital, reserve and similar requirements for banks that agree to limit their investments to high quality, short-term obligations, while maintaining a high degree of diversification and liquidity, then they should do so. The market can sort out whether such banks are competitive with money market funds, and if they are, shift assets to the special purpose banks. In other words, investors would be better served by regulators giving them additional choices for sound cash investment, rather than by regulators making the choice for them.

There is another sense in which the elimination of money market funds may not "accomplish the objective of reducing systemic risk," however—by not reducing the credit market's vulnerability to "freezing." Contrary to the implications of the PWG Report, Federated believes that investors who redeemed out of money market funds in September 2008 were running from what the funds held in their portfolios, rather than the funds themselves. During that period, investors lost confidence in the market's ability to evaluate credit risks. Their flight to government securities (including government money market funds), to such a degree that on several occasions Treasury bills were bid up beyond their face values, provides evidence of an overwhelming lack of investor confidence.

Even if money market funds had not existed, these investors would not have been willing to hold commercial paper or other credit instruments during this period. They would have stopped rolling their investments and would have tried to sell their holdings regardless of price. The credit markets still would have frozen solid and issuers would have been cut off from funding. In short, if market freezes are a result of cash investors' unwillingness to extend credit rather than their concerns about money market funds, then eliminating money market funds will not serve the objective of reducing this risk.

II. PROPOSALS NOT INVOLVING THE ELIMINATION OF SOME OR ALL MONEY MARKET FUNDS DESERVE FURTHER STUDY

Federated supports continued exploration of reforms that do not have the effect of eliminating money market funds. In particular, Federated supports the creation of a private emergency liquidity facility to help money market funds with sound portfolios deal with heavy redemptions during periods of market illiquidity. There is no need to add to the description of the captive liquidity facility provided in the ICI's comment letter. Federated continues to work closely with other industry leaders to finalize the details of this proposal. We encourage the members of the PWG to support our efforts to create an important liquidity buffer that will benefit the entire U.S. money market.

Federated also supports giving the directors of money market funds more tools with which to respond to defaults and adverse market conditions. For example, we have identified some of the major problems associated with redemption in-kind and included these in our comment letter to the Commission on the recent money market fund reforms. Federated has continued to analyze redemption in-kind and other possible responses to events that may threaten the stability of a money market fund's NAV (such as isolation of a defaulted security), and the planning required to respond immediately to these events. At the appropriate time, we would be willing to meet with the Commission or its staff to review our analysis of the issues raised in responding to such events and to discuss approaches to resolving these issues.

Although Federated remains open to the possibility of fund insurance, our experience suggests that this will not be a fruitful approach to reform. In the 1990s, Federated worked with an insurance company to develop a proprietary default insurance policy for its money market funds. Although we maintained the policy for several years, we were never able to obtain enough coverage for a large default such as the one suffered by the Reserve Primary Fund. The insurance company withdrew from the market, along with other companies offering similar policies, after the American General default. The PWG Report (p. 27) therefore correctly characterizes the business model for money market fund insurance as "challenging," and we suspect that there is no private business model that will prove viable for the long term.

As for government insurance, Federated opposes this approach on principle. Ultimately, a money market fund is just a type of mutual fund, and its shareholders should bear a risk of loss just as other mutual fund shareholders do. This is why investors are only justified in expecting funds to maintain a stable price *under normal market conditions*. In other circumstances, such as defaults or extremely volatile markets, investors should expect to bear the resulting losses. They should not expect the government, or even the adviser, to bail them out. The Commission may want to consider reforms that make the risk of incurring such losses more meaningful to investors.

Regarding the proposed "two tier system," this is the status quo. Implementing the emergency liquidity facility, redemption in-kind or even insurance through amendments to Rule 2a-7 would simply be part of these reforms, not a separate proposal. The PWG Report does not indicate what other "more stringent" provisions might be added to Rule 2a-7. Federated would not propose any at this time; we believe that having all money market funds consistently implement the most recent reforms would better serve the interest of shareholders.

III. CONCLUSION

To summarize, eliminating money market funds (by no longer permitting mutual funds to seek to maintain stable share prices) would, in addition to the problems noted in the PWG Report, have detrimental effects on cash investors, borrowers, the capital markets and, ultimately, the U.S economy. In addition, such a reform would cause a massive shift of assets to banks and direct investments that would increase the level of risk in the financial system without reducing the risk that credit markets may again "freeze up" in response to unexpected credit losses. If, notwithstanding our comments, the Commission or Financial Stability Oversight Council continues to consider such reforms, it is critical that they first attempt to quantify the full extent of the benefits and risks outlined in this letter.

On the other hand, proposals that would help the market deal with the consequences of wide-scale redemptions from money market funds should reduce the chances of frozen credit markets. This is why, of all of the reforms proposed in the PWG Report, an emergency liquidity facility deserves the most careful consideration. Creating a practical means of redeeming shareholders in-kind is probably the only other reform proposed in the report that might be attainable.

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

Yours very truly,

/s/ John W. McGonigle

John W. McGonigle
Vice Chairman