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June 20, 2012

RECEIVED
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OFFICE OF THE SECRETARY

The Honorable Mary Schapiro
Chairman
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

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

Dear Mary:

Enclosed is a copy of comments submitted by Federated Investors to the European Commission ("EC") on its Green Paper on "Shadow Banking" and, in particular, the Green Paper's treatment of money market mutual funds as "shadow banks."[1]

As Federated has outlined in these and other comments, money funds should not be labeled as any type of "shadow bank" and should not be subjected to banking-style regulations. Instead, money funds should continue to be treated as what they actually are – highly liquid investment funds by which investor cash is pooled and invested in money market assets – and regulated by securities regulators in a manner consistent with their actual structure and purpose.

The Commission has had a highly successful record with respect to the supervision and oversight of money funds. In fact, the 2010 amendments to SEC rules governing money funds have made them even more liquid, transparent and stable than ever before. Accordingly, the enclosed comments to the EC urge consideration of those reforms as a model for any new standards that may be adopted for global money funds. I appreciate the opportunity to provide you with Federated's comments to the EC, and hope they will be helpful to the Commission.

Sincerely,

Jerry

John D. Hawke, Jr.

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[1] Consultation on Shadow Banking (March 19, 2012) (*available at* http://ec.europa.eu/internal_market/consultations/2012/shadow_en.htm).

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Federated

WORLD-CLASS INVESTMENT MANAGER ®

June 15, 2012

Via E-Mail

Martin Merlin
Head of Unit
DG Internal Market and Services
DG MARKT Unit 02
Rue de Spa, 2 1049 Brussels
(Belgium)

Re: Comments of Federated Investors Inc. on European Commission Green Paper on "Shadow Banking"

Dear Mr. Merlin:

I am writing on behalf of Federated Investors, Inc. and its subsidiaries ("Federated"), and on behalf of money market mutual funds ("Federated Money Funds") for which a Federated subsidiary serves as investment adviser and distributor, to provide comments in response to the above-referenced Green Paper on "Shadow Banking," and in particular on the treatment of money market mutual funds ("Money Funds") as "shadow banks" in the Green Paper. Federated has served since 1974 as an investment adviser to Money Funds in the United States, and since 1991 as an investment adviser to Money Funds in Europe.

Federated has over thirty-eight years of experience in the business of managing Money Funds and, during that period, has participated actively in the money market as it has developed over the years. The registration statement for Federated's Money Market Management fund first became effective on January 16, 1974, making it perhaps the longest continuously operating Money Fund to use the Amortized Cost Method. Federated also received one of the initial U.S. SEC exemptive orders permitting use of the Amortized Cost Method in 1979. Federated is one of the largest investment management firms in the United States, managing $369.7 billion in assets as of December 31, 2011. Federated manages $285.1 billion in money market assets, of which $249.3 billion is in U.S. registered Money Funds and $6.5 billion is in short-term Money Funds domiciled in Ireland and the United Kingdom. In addition, Federated manages $29.3 billion in separate account and sub-advised money market portfolios. Federated provides comprehensive investment management to approximately 4,700 institutions and intermediaries, including corporations, government entities, insurance companies, foundations and endowments, banks and broker dealers.

Executive Summary

Federated, as a participant in the money markets and a sponsor of the Federated Money Funds, is interested in many of the details of the Green Paper and related policy discussions in Europe, the United States and elsewhere around the globe on the status and regulation of Money Funds. Federated supports the efforts of regulators to continually review the effectiveness of the existing regulatory program and to develop and adopt methods of prudent regulation of Money Funds. Adoption in 2009 of the revised "Undertakings for Collective Investment in

Transferable Securities" ("UCITS") which put in place a more comprehensive framework for the regulation of investment companies within Europe, has been a significant development.[1] The continuing work of the European Securities and Markets Authority ("ESMA") and its predecessor, the Committee of European Securities Regulators ("CESR"), to develop and implement common definitions, standards and requirements for Money Funds in Europe has also enhanced the regulation of Money Funds.

Federated suggests that, in order to identify potential enhancements to European Money Fund regulation, the European Commission should look to recent changes that have been adopted by the U.S. Securities and Exchange Commission ("SEC"), and to changes that have been implemented in trade association practice codes. Potential enhancements to consider include more specific requirements for portfolio liquidity and a "know your investor" requirement, more specificity on portfolio diversification requirements, and increased transparency on portfolio assets and their current market values, and a more defined process for moving from a constant net asset value (CNAV) to a variable net asset value (VNAV) in those unusual circumstances when such a change is needed due to economic conditions. In addition, enhanced supervisory analysis and follow-up on Money Fund portfolio risk, particularly consideration of red flags such as unusual growth or portfolio returns, and portfolio exposure to particular issuers, may be in order.

At the same time, Federated notes the enormous importance of Money Funds to the U.S., European and global economic systems. Misapprehension of their functions and characteristics may lead to application of inappropriate regulatory models to Money Funds, with potentially disastrous consequences. We strongly caution policymakers to understand and appreciate the far-reaching consequences of labeling Money Funds as "shadow banks" as a step toward imposing bank-like regulatory requirements on Money Funds. Such fundamental changes to the structure and regulation of Money Funds would threaten the ability of countless economic participants to use Money Funds in conducting basic, everyday business transactions.

Imposing bank-like regulatory requirements on Money Funds is an entirely untested concept and unwarranted under the circumstances. Imposing them under the guise of regulating Money Funds as "shadow banks" runs a serious risk of harm to short-term financial markets in which Money Funds invest. The consequences include a significant shrinkage of Money Fund assets and a shift of a large amount of liquidity balances from Money Funds to banks, separately managed accounts, repurchase agreements and other alternatives that are less efficient and potentially involve greater risks both to the investor and to the financial system. Movement of additional liquidity balances from Money Funds to banks would increase the size of the government commitment to provide liquidity and (if necessary) emergency capital infusion to already systemically significant "too big to fail" banks, at a time when government resources are already overstretched. Because Money Funds have significantly lower overhead and operating expense ratios than banks (by well over 200 basis points per annum), it is likely that, in a world without them, credit would be less available and far more costly to issuers that currently obtain funding in the short-term markets, which could have the effect of further dampening prospects for economic growth and job creation.

Respectfully, we urge the European Commission to refrain from implementing further fundamental changes to the regulation of Money Funds based on a bank regulatory framework and to instead conduct a careful analysis of the effectiveness of the 2009 UCITS Directive and 2010 CESR/ESMA Guidelines, as well as the 2010 amendments to SEC Rule 2a-7 to its oversight of Money Funds in order to determine whether any further changes to European

[1] Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to UCITS.

Money Fund regulation are warranted, and consider whether certain of the additional requirements contained in SEC rules applicable to Money Funds, as amended in 2010, that have not yet formally been adopted as part of the CESR/ESMA Guidelines should be added as a means to further enhance the European regulation of Money Funds.

Federated's response to the questions in the Green Paper are set forth in Appendix A.

Bank Regulatory Models Are Not Appropriate For Money Funds

Labeling Money Funds as "shadow banks" as proposed in the Green Paper is in our view inappropriate for several reasons, the most significant being that the label "shadow bank" strongly implies that Money Funds should be regulated like banks by the banking regulators, rather than regulated as investment funds by securities regulators. Shoehorning different types of financial firms into a bank regulatory model will have negative consequences. As applied to a Money Fund, these would include potentially weakening a crucial source of short-term funding, disrupting capital markets operations, and increasing systemic risk.

In addition, the term "shadow bank" is defined in the Green Paper to mean an entity that relies on leverage and bank-deposit-like financing to intermediate short-term financing with long-term lending portfolios. That definition does not accurately describe Money Funds generally, nor does it describe either subcategory of Money Funds (Money Market Funds and Short-Term Money Market funds) as set out in the May 2010 CESR (now ESMA) guidelines on a "Common Definition of European Money Funds" (ref. CESR/10-049) that went into effect in 2011.

Finally, "shadow bank" has become a pejorative term, and suggesting an unregulated and borderline illegal finance operation that operates like a bank in the shadows. In truth, Money Funds are thoroughly regulated and supervised by national securities regulators under the securities laws and subject to stringent operational, governance, portfolio investment and investor disclosure and public reporting requirements. In short, Money Funds are not banks and do not operate in the shadows.

Applying the label "shadow bank" to Money Funds seems little more than a pretext to apply bank regulatory concepts to Money Funds. Some of the changes to Money Fund regulation being advocated by bank regulators would impose "bank like" capital structures and regulatory requirements on Money Funds in a way that will be harmful not only to Money Funds and their investors, but also to the underlying money markets and issuers in those markets. We are concerned that certain changes being discussed will increase uncertainty, risk and volatility in the money markets and other fixed income markets, particularly in times of crisis. We believe the process for changes to regulation of Money Funds should include formal consideration of the effects of any proposed changes throughout the European economy and the financial system. This would help to ensure that efforts to constrain risks in Money Funds do not simply shift risk to other parts of the financial system where the exposure of governments, taxpayers and the financial system may be larger and more direct.

Applying bank-type regulations to Money Funds will have negative consequences, which would include weakening a crucial source of short-term funding, disrupting capital markets operations, and actually increasing systemic risk. Money Funds should be subject to robust regulation and supervision by the appropriate national securities regulators.

In the consideration of reforms to Money Fund regulation, the European Commission should be careful to do no harm to the financial system. Government actions taken with the best of intentions can have unintended consequences that cause more harm than good and increase financial instability. The European Commission should be careful not to adopt changes to Money Fund regulation that alter the structure of the financial services industry and the broader economy in a way that ultimately undermines financial stability, economic growth and efficiency.

The process should include formal consideration of the ripple effects of any proposed changes throughout the European economy and the financial system. We suggest that the consideration of structural and regulatory changes to Money Funds include formal consideration of whether the direct and indirect consequences of those actions would enhance systemic financial stability or detract from it. Formal consideration should also be given to whether the designation would result in further growth of the largest banks that are "systemically important financial institutions" (SIFIs) that are supported by the government safety net of deposit insurance and central bank lending and whose demise would be catastrophic.

Since 1985 in the United States alone, we estimate that Money Funds' higher yields have added over $500 Billion in returns to retain and institutional investors over bank deposits.[2] Money Funds have increased the returns to retail cash investors by at least $225 billion since 1985, when the ICI first started tracking Money Fund assets and yields. This estimate is based on the additional yield paid by the average retail Money Fund[3] over the rate paid on the average money market deposit account by banks, times the assets held in retail Money Funds. This estimate may underestimate the contributions of retail Money Funds, because (a) without competition from Money 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.

Because of substantially lower operating costs per dollar of assets (of 200 basis points or more per year), the cost to borrowers of obtaining financing through Money Funds is much lower than is available from commercial banks. The collateral effects of these benefits are improved capital formation and more efficient capital markets, and greater potential for economic growth.

Federated is concerned that the labeling of Money Funds as "shadow banks" will be used inappropriately as a basis to regulate Money Funds under a bank regulatory structure, with many unintended consequences across the European economy. Some are advocating drastic changes to the structure and regulation of Money Funds, including requiring all Short-Term Money Market Funds to use only a variable net asset value (VNAV), restrictions on the ability of investors to redeem shares, and introduction of financial leverage through a two-tier capital structure. We are concerned that the process will inappropriately impose requirements upon Money Funds that are neither necessary nor helpful, that will undermine their usefulness in the financial system, and that will increase risk in the financial system. The consequences of labeling Money Funds as "shadow banks" and imposing a bank regulatory framework upon Money Funds will reduce competition and the efficiency of the financial markets, coupled with a substantial increase in the size of the largest SIFI banks and the government safety net that supports them. It would also lead to a delay in settlement cycles, less efficient inter-firm automated

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[2] This is a conservative estimate, as it is unlikely that yields on bank deposits would have been as high without competitive pressure from Money Funds.

[3] The ICI did not track assets separately for retail and institution Money 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.

transaction processing systems, an increase in financing costs for business and government with resulting stress on jobs, economic growth and government deficits. Finally, it would cause harm to the European banking system through an inflow of large balance short term deposits, requiring banks to maintain additional capital and increasing funding risk and interest rate risk. These changes would result in more financial instability throughout the system, and lead to outcomes directly opposite of those intended by policymakers.

Before the European Commission labels Money Funds as "shadow banks" or considers forcing structural changes upon the Money Fund industry, it should thoroughly understand all of the consequences that would flow directly and indirectly from any such action.

Role of Money Market Funds in the Global Economy

Money Funds were first offered in the U.S. in 1971 as a way to preserve investor principal while earning a reasonable return – and for the first time made a market interest rate available to retail investors. Total assets of European Money Funds aggregate to approximately 1.05 trillion euros as of year-end 2011.[4]

According to IMMFA data on Money Funds of its member firms (which represent slightly less than half of total European Money Fund assets), portfolios of European Money Funds invest 34.7% of assets in commercial paper, 23.3% of assets in bank certificates of deposit, 18.4% of assets in bank time deposits, 9.6% of assets in floating rate notes, 1.5% of assets in government securities, 3.9% of assets in asset-backed commercial paper, and 8.6% of assets in repurchase agreements.[5]

Based on Investment Company Institute data, as of December 2011, there were approximately 632 U.S. Money Funds.[6] As of May 3, 2012, U.S. Money Funds held over $2.58 trillion in assets under management.[7] In the U.S., Money Funds account for investments in almost 40% of outstanding commercial paper, approximately two-thirds of short-term state and local government debt, and a substantial amount of outstanding short-term Treasury and federal agency securities.[8] During the 25 years from the adoption of SEC Rule 2a-7 in 1983 through 2009, over $335 trillion has flowed in and out of Money Funds at $1.00 a share.[9]

Money Funds have become widely held by many types of investors and are subject to comprehensive regulation and oversight by securities regulators. Due in large part to requirements to invest exclusively in specific high-quality, short-term instruments issued by financially stable entities, they also have enjoyed a high degree of

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[4] ICI, Supplementary Table S5, Total Net Assets in Euros by Type of Fund, Supplementary Table S4 Total Net Assets in U.S. Dollars by Type of Fund.

[5] IMMFA Money Fund Report, Chart: Average IMMFA fund composition, *available at* http://www.immfa.org.

[6] Investment Company Institute, 2012 Investment Company Fact Book at 171, *available at http://www.icifactbook.org.*

[7] Of this amount, retail Money Funds held approximately one third of the total and institutional funds held approximately two thirds of the total amount – though this distinction is somewhat arbitrary. Investment Company Institute, *Money Market Mutual Fund Assets*, May. 3, 2012, *available at* http://www.ici.org/research/stats/mmf/mm_05_03_12.

[8] *See* REPORT OF THE PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS, MONEY MARKET FUND REFORM OPTIONS 7, *available at* http://treas.gov/press/releases/docs/10.21%20PWG%20Report%20Final.pdf.

[9] *See* Investment Company Institute, *Report of the Money Market Working Group*, Mar. 17, 2009 (hereinafter "ICI Money Market Working Group Report"), at 38, *available at* www.ici.org/pdf/ppr_09_mmwg.pdf.

success, greatly increasing in number and in assets under management. Thus, Money Funds are now among the most widely held, low-risk and liquid investments in the world. Money Fund assets represented approximately 20% of global mutual fund assets as of year-end 2011, and totaled approximately $4.69 trillion.[10] Slightly less than half of global Money Fund assets were in European or other non-U.S. Money Funds.[11]

In Europe, requirements applicable to investment funds are established by the UCITS directive. Initially, more specific requirements for Money Funds were established through industry trade association best practices,[12] rating agency requirements, and by the governing instruments of the funds. In May 2010, after several years of study, the CESR (predecessor to ESMA) adopted guidelines for Money Funds, which became mandatory in 2011.[13]

Money Funds are leading investors in the short-term debt instruments that are issued and traded in the "money market," including government securities, bankers' acceptances, certificates of deposit, and commercial paper.[14] The money market is the single most important source of liquidity funding for the global financial system. It permits large institutions to meet short-term borrowing needs and invest cash holdings for brief periods. Issuers in the money market include companies whose financial strength allows them to issue commercial paper directly to buyers, without credit support or collateral. National, regional and local governments also use the money market to meet liquidity needs by issuing short-term paper. Even the United States Federal Reserve utilizes Money Funds in its reverse repurchase program.

For investors of all types, Money Funds offer numerous benefits. In Europe, Money Funds come in several forms, including "Short Term Money Market Funds" which must maintain a weighted average maturity of portfolio assets of 60 days or less and can choose either to have either a constant net asset value ("CNAV") using amortized cost accounting to value portfolio assets and price shares, or a variable net asset value ("VNAV") using mark-to-market valuations of portfolio securities at which share prices are reported, issued and redeemed, and "Money Market Funds" which must have VNAV but are permitted to invest their portfolios with a slightly longer weighted average life and weighted average maturity. In addition, both types of European Money Funds can

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[10] Investment Company Institute, *Worldwide Mutual Funds Assets and Flows, Fourth Quarter 2011* (April 12, 2012), available at http://www.ici.org/research/stats/worldwide/ci.ww_12_11.

[11] As of May 3, 2012, U.S. Money Funds had over $2.58 trillion in assets under management. *See* Investment Company Institute, *Money Market Mutual Fund Assets*, May. 3, 2012, *available at* http://www.ici.org/research/stats/mmf/mm_05_03_12. Investment Company Institute historical weekly money market data show that assets under management have declined significantly since January 2009. As of January 7, 2009, U.S. Money Funds had over $3.8 trillion in assets. *See* Investment Company Institute, *Weekly Total Net Assets (TNA) and Number of Money Market Mutual Funds*, *available at* http://www.ici.org/pdf/mm_data_2010.pdf.

[12] *See* Institutional Money Market Funds Association ("IMMFA") *Code of Practice*, available at http://www.immfa.org.. The asset values of Money Funds managed by IMMFA member firms aggregated to approximately 450 billion euros as of June 2011, or slightly less than half of total European Money Fund assets. See IMMFA Money Fund Report chart-- IMMFA Members funds under management, available at http://www.immfa.org.

[13] CESR's Guidelines on a common definition of European money market funds (CESR/10-049, May 19, 2010).

[14] Commercial paper consists of short-term, promissory notes issued primarily by corporations with maturities of up to 270 days but averaging about 30 days. Companies use commercial paper to raise cash for current operations as it is often cheaper than securing a bank loan. Federal Reserve Board, *Commercial Paper, available at* http://www.federalreserve.gov/releases/cp/about.htm.

choose to operate in Euros or in another currency, which is used to invest portfolio assets, price shares and report to shareholders.

In the U.S., Money Funds correspond to "Short Term Money Market Funds" under the CESR/ESMA standards, and include both taxable funds (which invest in securities such as Treasury bills and commercial paper) and tax-free funds (which generally invest in municipal securities). The slightly-longer term European category "Money Market Funds" corresponds more closely to U.S. "ultra short" bond funds that must use VNAV and are not considered to be "Money Funds" under the United States system of regulation.[15] U.S. Money Funds that invest in short-term corporate and bank debt, but not government securities, are also known as "prime" Money Funds.[16] Investors can choose between and among funds that offer slightly higher yields, funds that offer less credit risk, and funds that offer tax advantages. For institutional investors, Money Funds offer low cost, diversified and convenient ways to invest cash in the short-term. Many institutional investors, including companies and governmental entities, have cash balances swept from their operating accounts into Money Funds on a nightly basis. For retail investors, Money Funds continue to offer a low-risk, low-expense way to diversify liquid holdings.

In Federated's view, the term Money Fund should be limited to funds that meet stringent requirements for portfolio credit quality, diversification, very short maturity and liquidity that are appropriate to maintaining a constant value. For example, U.S. ultra-short bond funds should not be considered Money Funds and European Money Funds that are not "short term" Money Funds under the CSER/ESMA Guidelines, in Federated's view, should not be brought within the definition of Money Market Fund. To do so muddles both investor understanding of the product and the policy debate over regulation of Money Funds.

Impact on Cost and Availability of Credit to Businesses and Governments

Money Funds are a vital source of funding for the European and global economy. Money Funds provide critical financing to every sector of the short-term credit market. If Money Funds were taken out of the financial system, and the role currently performed by Money Funds in providing short-term financing was performed solely by commercial banks, the European and global economy would be harmed through increased financing costs to business and governments.[17]

Banks are far less efficient than are Money Funds in providing funding to corporate and government borrowers in the money markets. Banks have overhead costs – principally occupancy and staff expense – that are higher per dollar of assets than the operations costs of Money Funds. A comparison of expense data contained in aggregate

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[15] *See* Sue Asci, *Prime Money Funds See Recent Inflows*, Investment News, Feb. 22, 2009.

[16] In this regard, European regulators may wish to consider harmonizing terminology with U.S. practices. This would serve to avoid confusion in international transactions.

[17] Comments filed with the SEC in response to the PWG Report by numerous public and private issuers of short-term debt confirm their concerns that significant reforms to money fund regulation may have serious negative effects on their ability to obtain short-term financing (*See* attached Appendix A, *Summary of Comments on Floating NAV*). The Center for Capital Markets Competitiveness of the U.S. Chamber of Commerce has also written to SEC Chairman Schapiro to urge caution before implementing reforms to the regulation of money funds because they "represent a major source of funding to the $1.1 trillion commercial paper market" and because "[c]orporate treasurers rely on [them] to efficiently and affordably manage liquidity." Letter from David Hirschmann to SEC Chairman Mary Schapiro (Nov. 17, 2011) (copy attached).

call report data on U.S. banks[18] with expense ratios of U.S. Money Funds[19] shows that Money Funds are far more efficient than banks in recycling investor cash into financing of businesses and governments, and the size of the efficiency differential in the U.S. is between 200 and 300 basis points per year per dollar of assets. As of year-end 2010, the average expense ratio for U.S. Money Funds was 32 basis points.[20] By comparison, the non-interest overhead expenses (including costs of personnel, office space, deposit insurance premiums, marketing, etc.) represented over 3% of average assets for U.S. banks.[21] This suggests that it costs 2.5% more per annum for a U.S. bank to intermediate each dollar's worth of balances from savers to borrowers as compared to a Money Fund. The high bank cost structure affects not only the banks themselves, but also means borrowers must pay more to obtain financing from banks, in contrast with the lower financing costs of businesses and governments whose short-term paper is held by Money Funds. This large cost differential means there is much less efficiency, lower returns to savers, and higher costs to borrowers when balances are intermediated through the banking system.

This large expense differential is also reflected in the interest rates on commercial paper, which are far lower than rates on bank loans. Federal Reserve Board statistics indicate that U.S. bank loans are consistently more expensive – often 200 basis points or more – than rates on U.S. commercial paper.[22] On approximately $4.69 trillion in aggregate Money Fund balances,[23] that would amount to between $88 billion and $141 billion in annual costs to investors and borrowers that would be incurred by moving these balances to intermediation through banks. Absent a compelling reason, there is no way to justify hanging a millstone of that size around the neck of the global economy. If Money Funds disappeared and were fully replaced by banks, the higher cost of borrowing would translate directly into less economic growth, fewer jobs, and less money available for governments to provide services. The additional cost to issuers would constrain profitability and growth of issuers by increasing the cost of financing their operations, and would push government borrowers that much further into the red, requiring even further cuts to government programs, payrolls, pensions and benefits.

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[18] Federal Financial Institutions Examination Council, *Uniform Bank Performance Report, Peer Group Average Report for All Banks in Nation* as of September 30, 2011 *available at* https://cdr.ffiec.gov/public/ManageFacsimiles.aspx.

[19] *See 2011 Investment Company Fact Book* at 63.

[20] *2011 Investment Company Fact Book*, at 68 *available at* http://www.ici.org/pdf/2011_factbook.pdf. This is down from 2009's 54 points, because many funds waived expenses to ensure positive returns for investors while interest rates are being kept low. *2010 Investment Company Fact Book*, at 68 *available at* http://www.icifactbook.org/pdf/2010_factbook.pdf; *ICI Research Perspective: Trends in the Fees and Expenses of Mutual Funds, 2010*, Investment Company Institute, at 1 (Mar. 2011).

[21] Federal Financial Institutions Examination Council, *Uniform Bank Performance Report, Peer Group Average Report for All Banks in Nation* as of September 30, 2011 (available at https://cdr.ffiec.gov/public/ManageFacsimiles.aspx).

[22] Selected Interest Rates (Daily) for September 14, 2011 (showing rates for commercial paper and bank prime loans); Interest Rates for 90-Day AA Nonfinancial Commercial Paper 1997 - 2010 and Average Majority Prime Rate Charged by Banks on Short Term Loans to Business, 1956 - 2010. These reports are available on the website of the Federal Reserve Board, which publishes this data at http://www.federalreserve.gov/econresdata/releases/statisticsdata.htm.

[23] Investment Company Institute, *Worldwide Mutual Funds Assets and Flows, Fourth Quarter 2011* (April 12, 2012), available at http://www.ici.org/research/stats/worldwide/ci.ww_12_11.

Performance of Money Funds During the Financial Crisis

Even in times of greatest financial stress, Money Funds have proved to be more stable than depository institutions. Since February 2007, as a result of the financial crisis that followed the burst of the housing bubble and the collapse of mortgage-backed securities investments, 440 U.S. banks have failed,[24] and even more would have failed but for dozens of federal programs that infused banks with cash. The example cited for the need for additional regulation of Money Funds has been the Reserve Primary Fund's "breaking a buck" on September 17, 2008, during the darkest days of the Financial Crisis. Before that event occurred, the global economy had been in a deep recession for well over a year.

- After years of investing in risky subprime mortgages and related securities, Freddie Mac and Fannie Mae began scaling back their involvement in subprime mortgage lending in February 2007.
- HSBC announces $18.4 billion in loss reserves on mortgages, February 8, 2007.
- Large participants in the subprime mortgage markets started failing, the first being New Century Financial Corporation in April 2007.
- In July 2007, two Bear Sterns controlled hedge funds heavily invested in collateralized debt obligations (CDOs) backed by subprime mortgages collapsed.
- The securitization markets dried up in the Summer of 2007.
- During August 2007, a series of mortgage lenders, including American Home Mortgage, Thornburg Mortgage Inc., and Capital One Financial Corp, either closed their doors or stopped funding new residential mortgages.
- The turmoil and freezing up of the credit markets prompted an unprecedented meeting on August 21, 2007 among then Senate Banking Committee Chair Dodd, then Treasury Secretary Paulson, and Federal Reserve Chairman Bernanke, in which Chairman Bernanke pledged to use all tools available to stem the credit crunch.
- Northern Rock receives emergency funding from the Bank of England September 2007.
- European Central Bank provides $500 billion in emergency funding to European commercial banks, December 2007.
- Credit ratings of mono-line bond insurers downgraded, December 17, 2007.
- Largest stock market drop since 2001 occurs on January 21, 2008.
- Mortgage bond insurer MBIA announces $2.3 billion loss on subprime loan exposure, January 31, 2008.
- Northern Rock nationalized, February 17, 2008.
- The auction rate securities market dried up in February 2008.
- Fourteen FDIC-insured banks failed between January 1, 2007 and September 15, 2008.

[24] FDIC Failed Bank List, *available at* http://www.fdic.gov/bank/individual/failed/banklist.html.

- HSBC announces additional loan losses of $17 billion, March 3, 2008.
- Bear Stearns had to be rescued in March 2008.
- UBS announces loan write down of $19 billion, April 1, 2008.
- Royal Bank of Scotland announces £5.9bn loan loss, April 22, 2008.
- Countrywide was forced to be sold in June 2008.
- IndyMac failed in July 2008.
- Fannie Mae and Freddie Mac were placed in conservatorship on September 6, 2008.
- Merrill Lynch was forced to sell to Bank of America to avoid insolvency during the second week of September 2008.
- Lehman Brothers went into bankruptcy on September 15, 2008.
- AIG was bailed out with an $85 billion loan from the Federal Reserve on September 16, 2008.
- Starting on September 16, 2008, both Washington Mutual Savings Bank and Wachovia Bank experienced massive runs on commercial deposits causing both institutions to become liquidity insolvent. Washington Mutual was closed and placed in receivership (the largest bank failure in U.S. history) and Wachovia was sold to Wells Fargo to avoid an even larger receivership.
- On September 16, 2008, roughly 20 months into the Financial Crisis, the Reserve Primary Fund broke a buck as a result of its Lehman commercial paper holdings, experienced a run on redemptions and suspended redemptions of its shares. Reserve Primary Fund Shareholders eventually recovered over 99 cents on the dollar in the liquidation of the fund.
- Lloyds TSB takes over Britain's largest mortgage lender, HBOS, September 17, 2008.

The Reserve Primary Fund's breaking a buck did not cause the Financial Crisis to occur. The Financial Crisis, which had been raging for 20 months, was a key ingredient in the failure of many large institutions, including Lehman Brothers. The failure of Lehman caused the Reserve Primary Fund to break a buck. The failure of the federal government to support Lehman Brothers (which support had been anticipated by many market participants) and the bankruptcy of Lehman Brothers, coming a most simultaneously with the collapse and federal support provided to AIG shortly after the credit rating agencies had endorsed its high rating, caused a panic among investors and hastened the flight to quality that include a run on large corporate bank deposits as well as redemptions from prime Money Funds (and transfer of balances into government securities Money Funds). The Reserve Primary Fund situation was an effect, not a cause, of the Financial Crisis.[25]

The U.S. Federal Reserve Board, Department of the Treasury, and FDIC spent approximately $2 trillion on an array of programs to infuse cash into the banking system.[26] In addition, the Federal Reserve Board has kept

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[25] For a detailed analysis of investment flows and impact of events during the Financial Crisis on Money Funds *see, generally*, Treasury Strategies, Inc., *Dissecting the Financial Collapse of 2007-2008, A Two-Year Flight to Quality* (May, 2012), available online at http://www.sec.gov/comments/4-619/4619-188.pdf.

[26] Congressional Oversight Panel, *September Oversight Report: Assessing the TARP on the Eve of Its Expiration*, at 145-146 (Sept. 16, 2010).

interest rates close to zero, allowing banks to borrow at almost no cost and to lend at higher rates so as to practically guarantee risk-free profits. This is estimated to cost savers $350 billion each year as banks do not have to compete for depositors' funds, and therefore may offer only low interest rates on deposits.[27]

During the same period, only one U.S. Money Fund, the Reserve Primary Fund, failed to immediately return investors' shares at less than 100 cents on the dollar, and shareholders ultimately received more than 99 cents on the dollar.[28] Nonetheless, the massive requests for redemptions by the Reserve Primary Fund shareholders beginning on September 15, 2008 when Lehman declared bankruptcy, the government announced a bailout of AIG on September 16, and the Reserve's announcement the next day that it would re-price its shares, triggered a run by investors in other prime Money Funds who feared that those funds' holdings of commercial paper of other financial institutions would decline in value. Much of the redeemed prime Money Fund shareholder money was used by shareholders to purchase shares of U.S. government securities Money Funds. Numerous prime Money Funds liquidated assets and a number of funds obtained support from their advisers or other affiliated persons.[29] As the U.S. President's Working Group (PWG) Report on Money Funds describes, the liquidation of Money Fund assets to meet redemptions led to a reduction of Money Fund holdings of commercial paper by about 25 percent.[30]

No U.S. Money Funds were "bailed out" by the U.S. government during the financial crisis, but the extraordinary conditions in the market, including illiquidity in the secondary market for commercial paper, led to the adoption of special measures to restore confidence in the money markets and Money Funds and address the freeze-up in the commercial paper market. The Treasury Department implemented a limited "Temporary Guarantee Program for Money Market Funds" whereby Money Funds could, in exchange for a payment, receive insurance on investors' holdings such that if shares broke the buck, they would be restored to a $1 CNAV.[31] The program expired about

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[27] Yalman Onaran and Alexis Leondis, *Wall Street Bailout Returns 8.2% Profit Beating Treasury Bonds*, Bloomberg (Oct. 20, 2010), *available at* http://www.bloomberg.com/news/2010-10-20/bailout-of-wall-street-returns-8-2-profit-to-taxpayers-beating-treasuries.html.

[28] On September 16, 2008, the Reserve Primary Fund's shares were priced at 97 cents after it wrote off debt issued by Lehman Brothers, which had declared bankruptcy the day before. Even so, this event was in large part due to misconduct by the Fund's management, as the SEC has alleged in a pending enforcement proceeding. *See* SEC Press Release: *SEC Charges Operators of Reserve Primary Fund With Fraud*, May 5, 2009, *available at* http://www.sec.gov/news/press/2009/2009-104.htm and related SEC Complaint, *available at* http://www.sec.gov/litigation/complaints/2009/comp21025.pdf, at 35. Moreover, Reserve Fund shareholders recovered more than 99 cents on the dollar after it closed. Press Release, *Reserve Primary Fund to Distribute $215 Million* (July 15, 2010), *available at* http://www.reservefunds.com/pdfs/Primary%20Distribution_71510.pdf; SEC Press Release: *Reserve Primary Fund Distributes Assets to Investors* (Jan. 29, 2010), *available at* http://www.sec.gov/news/press/2010/2010-16.htm.

[29] The SEC notes that with the exception of the Reserve Primary Fund, all of the funds that were exposed to losses during 2007-2008 from debt securities issued by structured investment vehicles or as a result of the default of debt securities issued by Lehman Brothers Holdings Inc. obtained support of some kind from their advisers or other affiliated persons, who absorbed the losses or provided a guarantee covering a sufficient amount of losses to prevent these funds from breaking the buck. *See* Release No. IC-29132, 75 Fed. Reg. 10060, 10061 (Mar. 4, 2010).

[30] *See* REPORT OF THE PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS, MONEY MARKET FUND REFORM OPTIONS 12, *available at* http://treas.gov/press/releases/docs/10.21%20PWG%20Report%20Final.pdf.

[31] Press Release, *Treasury Announces Guaranty Program for Money Market Funds* (Sept. 29, 2008), *available at* http://www.treas.gov/press/releases/hp1147.htm.

one year later, experienced no losses (because the insurance guarantee was never called upon), and earned the Treasury about $1.2 billion in participation fees.[32]

The Federal Reserve also created an "Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility" ("AMLF") to provide credit for banks and bank holding companies to finance their purchases of commercial paper from Money Funds and thereby provide support for the commercial paper market.[33] This program lent $150 billion in just its first 10 days of operation and was terminated with no credit losses.[34] All loans made under the AMLF were repaid in full, with interest, in accordance with the terms of the facility.[35] Indeed, the Federal Reserve Bank of Boston Statements of Income and Comprehensive Income for the years ended December 31, 2009 and December 31, 2008 show the total amount of interest income made on "other loans" (which refers to the AMLF program) during 2008 and 2009 was $543 million ($470 million and $73 million in 2008 and 2009, respectively).[36] Advances made under the AMLF were made at a rate equal to the primary credit rate offered by the Boston Federal Reserve Bank to depository institutions at the time the advance was made.[37] In sum, the program was extremely profitable to the government. Both programs were limited in scope and involved relatively low risk to taxpayers when compared to other steps taken by the government during the financial crisis.

The AMLF financing program put in place by the Federal Reserve to lend to banks that bought commercial paper from Money Funds, while significant and very successful (and profitable to the Federal Reserve), was a very small part of a massive injection of liquidity into banks, GSEs and the financial markets by the Federal Reserve, FDIC and Treasury during the crisis, the vast majority of which had no relation to Money Funds. Most recently, the Federal Reserve disclosed that its total discount window loans to banks unrelated to Money Funds during the crisis aggregated to over $7.7 trillion dollars, of which $1 2 trillion was outstanding at its peak. All in, the emergency lending programs in place during the financial crisis aggregated over $30 trillion, although the net balance outstanding at any given time was much lower.[38]

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[32] Press Release, *Treasury Announces Expiration of Guarantee Program for Money Market Funds* (Sept. 19, 2009), *available at* http://www.ustreas.gov/press/releases/tg293.htm.

[33] Federal Reserve Board, *Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility, available at* http://www.federalreserve.gov/monetarypolicy/abcpmmmf.htm.

[34] Burcu Duygan-Bump, Patrick M. Parkinson, Eric S. Rosengren, Gustavo A. Suarez, and Paul S. Willen, QAU Working Paper No. QAU10-3, *How Effective Were the Federal Reserve Emergency Liquidity Facilities? Evidence from the Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility* (available at http://www.bos.frb.org/bankinfo/qau/wp/2010/qau1003.htm). The program ceased operation in February, 2010. Federal Reserve Board Press Release, FOMC Statement (Jan. 27, 2010), *available at* http://www.federalreserve.gov/newsevents/press/monetary/20100127a.htm.

[35] Federal Reserve Board, *Monthly Report on Credit and Liquidity Programs and the Balance Sheet,* Appendix B at 31 (October 2010), *available at* http://www.federalreserve.gov/monetarypolicy/files/monthlyclbsreport201010.pdf.

[36] *See* The Federal Reserve Bank of Boston, Financial Statements as of and for the Years Ended December 31, 2009 and 2008 and Independent Auditors' Report, *available at* http://www.federalreserve.gov/monetarypolicy/files/BSTBostonfinstmt2009.pdf.

[37] *Id.*, at 19.

[38] *See* Federal Reserve Board, Usage of Federal Reserve Credit and Liquidity Facilities (Nov. 30, 2011), *data available at:* http://www.federalreserve.gov/newsevents/reform_transaction.htm; Press release, Department of the Treasury, Treasury and

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Shadow Banking Entities – Definition

Money Funds Are Not "Shadow Banks"

Bank regulators recently have called for bank-type regulation of Money Funds on the theory that they are "shadow banks." Until recently, the term "shadow bank" meant an offshore parallel bank operating in an unregulated jurisdiction and often engaged in shady dealings. During the financial crisis, the term was repurposed by bank regulators as a pejorative label for segments of the financial services industry that were not subject to bank-like regulation.[39] As redefined, the term "shadow bank" has been used to mean an unregulated financing vehicle with a lot of leverage and little capital.[40] The exemplar is a securitization vehicle, with an asset base of loans and receivables and a capital structure consisting of a couple of percentage points of equity, a tranche of subordinated debt, and a large amount of secured short-term notes, commonly referred to as "asset backed commercial paper" ("ABCP").

Money Funds differ from these entities in that they are heavily regulated by the relevant national securities regulators, subject to extensive audit, public reporting and transparency requirements, and do not use leverage. Unlike "shadow banks," Money Funds are financed 100 percent by common equity. In essence, Money Funds do not meet any of the criteria used to define a "shadow bank."

Some in the policy debate have sought to label Money Funds' shares as "debt" (it is equity), argue that shareholders have a "put" to the fund or its manager at $1 per share (they do not)[41] or that the manager or the fund "guarantees" the constant net asset value (CNAV) share price (such as one euro, pound or dollar per share) (they do not). To the contrary, Money Fund investors receive explicit disclosure that investments in Money Funds are not bank deposits and may lose value and are not insured or guaranteed.

Footnote continued from previous page
Federal Housing Finance Agency Action to Protect Financial Markets and Taxpayers (Sept. 7, 2008) *available at:* http://www.treasury.gov/press-center/press-releases/Pages/200897111172217483.aspx; Federal Reserve Bank of St. Louis, The Financial Crisis: A Timeline of Events and Policy Actions (Apr. 13, 2011), *available at* http://timeline.stlouisfed.org/

[39] Zoltan, Pozsar, et al., Tobias, Federal Reserve Bank of New York, Staff Report no. 458, Shadow Banking, at 4 (July 2010) ("We use the term 'shadow banking system' for this paper, but we believe that it is an incorrect and perhaps pejorative name for such a large and important part of the financial system.") *available at* http://www.ny.frb.org/research/staff_reports/sr458.pdf. The first use of the term "shadow bank" in August 2007 to refer to ABCP and similar off-balance sheet issuers was apparently by an economist and management officials at a mutual fund management firm, PIMCO, who were seeking to draw bank regulatory policy makers' attention to the risks inherent in the bank regulators allowing these financing structures to grow. *See* Bill Gross, *Beware our shadow banking system*, Fortune Magazine (Nov. 28, 2007) *available at* http://money.cnn.com/2007/11/27/news/newsmakers/gross_banking.fortune/; McCulley, PIMCO Global Central Bank Focus, *The Shadow Banking System and Hyman Minsky's Economic Journey* (May 2009). In a classic display of the maxim that "no good deed goes unpunished," the U.S. federal bank regulators who ignored these warnings about the risks associated with ABCP and other off-balance sheet financing in 2007 and early 2008, have now sought to blame the problem on the mutual fund industry that called the issue to their attention in the first place.

[40] The Financial Crisis Inquiry Report: Final Report of the National Commission of the Causes of the Financial and Economic Crisis in the United States, at xxi, 27-37 (Jan. 2011) *available at* http://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf.

[41] SEC Roundtable Discussion on Money Funds and Systemic Risk (May 10, 2011) (archived webcast *available at* http://www.sec.gov/news/otherwebcasts/2011/mmf-risk051011.shtml).

The Green Paper defines the "shadow banking system" to mean "'the system of credit intermediation that involves entities and activities outside the regular banking system'". The Green Paper further describes the "shadow banking system" as being based on two "intertwined pillars" the first part being that the entities exist outside the "regular" banking system and engage in:

- accepting funding with deposit-like characteristics;
- performing maturity and/or liquidity transformation;
- undergoing credit risk transfer; and,
- using direct or indirect financial leverage.

The second "pillar" of the characteristics that define shadow banking in the Green Report is the ability to provide financing to non-banking entities. Given that this second part could refer to any person, government, non-governmental organization or business entity with money to lend or invest, the first pillar appears to be the part of the definition which requires closer consideration.

According to the Green Paper, Money Funds fit the definition of a "shadow bank" because Money Funds have "deposit-like characteristics, which make them vulnerable to massive redemptions ("runs")." Money Funds, however, do not accept "deposit-like" funding. Money Funds have shareholders, who are equity owners of the Money Fund. Unlike depositors, Money Fund shareholders are not creditors.[42] The Money Fund does not promise or guarantee the shareholders will receive 100 cents on the euro (or on the pound or on the dollar) when Money Fund shares are redeemed. Regardless of whether it is a CNAV Short-Term Money Market Fund or a VNAV Money Market Fund, it is the shareholders who ultimately bear the risk of portfolio losses. Although managers of Money Funds use best efforts to manage the fund's portfolio to avoid losses and maintain a constant value, they clearly disclose to investors that the fund may break a buck and if it does, the investor may suffer losses. To put it another way, Money Funds do not engage in credit risk transfer in the way a bank does. Investors bear the risk of credit losses on portfolio assets of the Money Fund precisely because they are not creditors of the Money Fund. In contrast, bank depositors are creditors of the bank. If the bank's loan portfolio suffers losses, the amount owed by the bank to its depositors does not decrease. While in some cases, the manager of a Money Fund may choose to step in and buy out at par value an illiquid or troubled asset from the Money Fund's portfolio, the manager does not promise to do so *ex ante*, is not contractually committed to do so, and is not legally required to do so. Instead, Money Funds are required to clearly disclose to investors that shares may lose value.

CNAV is a Result of Very Short-Term Portfolio Assets

A significant aspect of the regulation of Money Funds is the criteria for calculating the net asset value (NAV) of a fund. The CNAV, which is essential for many commercial uses of Money Funds, is not an accounting gimmick, and is not maintained by a guarantee by the sponsor or anyone else. Calculating CNAV relies upon a method of accounting widely utilized by other types of institutions and recognized and approved by other regulators in circumstances where the variation between the true "mark to market" value of an instrument and the value using the amortized cost method is significantly wider (and less knowable and less transparent) than is the case with

[42] *See* UCITS Directive, Article 83; CESR/ESMA Guidelines at page 3.

Money Funds. (A description of the history underlying the use of CNAV by Money Funds and its recognition by regulators is attached as Appendix B). These issues are discussed in more detail below.

Mechanics of Calculating NAV of a Money Fund. Money Funds are not complicated. Each Money Fund is just a portfolio of short-term debt investments owned in a pool for a single class of shareholders. There is no debt or other borrowing by the Money Fund. It is 100% equity. Investors are permitted to purchase or redeem shares of a Money Fund every business day. It is therefore necessary to have a method of calculating the price at which shareholders may purchase or redeem shares every day. Like all mutual funds, Money Funds set the daily price for purchases and redemptions of shares at that day's net asset value (NAV). Like all mutual funds, a Money Fund calculates its daily NAV per share by determining the value as of that day of each and every asset held and adding them up to determine a gross portfolio asset value, subtracting any liabilities (there generally are not any) and accrued expenses to reach a net portfolio asset value, and then dividing the net portfolio value by the number of shares of the Money Fund currently issued and outstanding. As with most other mutual funds, this share price is rounded up or down to the nearest cent. Essentially, NAV per share is the value of each shareholder's pro rata slice of the overall assets of the fund.

The share price calculations of Money Funds differ from the share price calculations of other mutual funds in two respects. First, Money Funds are permitted to use "amortized cost" to value the individual short-term portfolio securities they own, while other mutual funds use a mark-to-market price to value most portfolio securities. Second, because they use "amortized cost," Money Funds are able to calculate NAV and set share purchase and redemption prices early in the day, while other mutual funds must wait until after the markets close to obtain the closing market price inputs needed to "market value" each portfolio security and calculate NAV and thus the purchase and redemption prices of their shares. This ability to know at the beginning of the day that, absent an unforeseen major credit event that brings NAV below 99.5 cents per share, the shares will be priced at a dollar at the end of the day is a key feature of Money Funds that allows them to be used to hold short term liquidity in connection with a range of commercial systems.

The CESR/ESMA Guidelines permit a Short-Term Money Market Fund to use the "amortized cost" method of accounting for the value of assets held in portfolio. Similarly, SEC Rule 2a-7 permits a Money Fund to use "amortized cost".[43] This method of valuing short-term debt instruments, and rounding share prices to the nearest penny, is a convenience that allows investors, broker-dealers, banks, investment advisers and Money Funds to keep track of asset values (and indirectly, customer account values which are calculated by dividing the total net value of the portfolio by the number of outstanding shares of the Money Fund) without account-level daily price tracking of fractions of a cent. This use of constant NAV pricing is permitted by SEC rules only for funds that comply with the strict requirements of Rule 2a-7 to ensure that these funds are as stable and low risk as possible, and only for so long as the NAV calculated using the amortized cost value of the portfolio does not materially depart from the shadow price of shares calculated using mark-to-market assets values. A Money Fund must meet stringent portfolio liquidity, credit quality, maturity, and diversification requirements. These requirements were strengthened in the United States by amendments in 2010 that were "designed to make money market funds more

[43] Under the "amortized cost" method of accounting, Money Funds value the securities in their portfolios at acquisition cost as adjusted for amortization of premium or accretion of discount rather than market value. *See* 17 C.F.R. § 270.2a-7(a)(2). The Rule also allows Money Funds to use the "penny-rounding" method of pricing, which permits rounding to one cent rather than one-tenth of a cent. 17 C.F.R. § 270.2a-7(a)(20). However, this method is seldom used because it does not eliminate daily "mark to market" accounting requirements.

resilient to certain short-term market risks, and to provide greater protections for investors in a money market mutual fund that is unable to maintain a stable net asset value per share."[44]

Money Fund shares price at a dollar on a daily basis not because they have promised to repay shares at a dollar (Money Funds do not make that promise and explicitly state otherwise) but because the aggregate daily value of all of the portfolio assets of the Money Fund, minus expenses and any liabilities, divided by the number of issued and outstanding shares, is worth, that day, between 99.5 cents and 100.5 cents per share. The managers of Money Funds work diligently to choose investments for the portfolio of the Money Fund so that the NAV per share will calculate every day to something very close to $1.00 per share, and generally the daily NAV before rounding to the nearest penny, is between 99.9 cents and 100.1 cents per share.

The price difference between using amortized cost and market prices to value underlying portfolio securities is not significant for short term, high quality debt instruments of the types owned by Money Funds. Short-term paper is normally issued at a discount from the par value at maturity which represents the imputed interest over the days between the issuance date and the maturity date. Amortized cost is determined by subtracting the purchase price of the instrument from its pending maturity value, dividing the small difference by the number of days remaining to maturity, and, for each day from the purchase date to the maturity date, adding to the purchase price one day's worth of the price difference.

This is not an accounting gimmick. The use by Short-Term Money Market Funds of amortized cost accounting recognizes that the underlying market value of the assets held by a Short-Term Money Market Fund are, and are required to be, types of assets for which the market value generally will not fluctuate from amortized cost to any material degree. Short-Term Money Market Fund assets are short term to avoid interest rate and liquidity risk and long-term credit risk. Money Fund assets are diversified and high credit quality to minimize credit risk. The ability of Short-Term Money Market Funds to maintain a CNAV is the result of very stringent portfolio restrictions that apply under the CESR/ESMA Guidelines and SEC regulations.

Similar to standards imposed under UCITS, amortized cost can only be used by a U.S. Money Fund if the fund's board determines that use of amortized cost does not resulting in a materially different NAV than the use of market pricing. In particular, amortized cost cannot be used to value a security if there has been an event, such as a default or significant downgrade of the issuer, that makes the use of amortized cost not an accurate approximation of the true value of the portfolio security. Those portfolio securities must be marked to market. Use of amortized cost to value short term high quality debt instruments with 60 days or less of remaining maturity is consistent with U.S. GAAP valuation principles for any issuer (not just Money Funds), and was permitted and used by mutual funds and other public companies long before Money Funds were created.[45] Under SEC Rule 2a-7 as amended in 2010, the debt instruments held by a U.S. Money Fund have average maturities below 60 days.

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[44] *See* SEC Release No. IC-29132, 75 Fed. Reg. 10060 (Mar. 4, 2010).

[45] Notably, the strongest advocates for the use of amortized cost and other historical cost methods for valuing balance sheet assets have been the members and staff of the Board of Governors of the Federal Reserve System. *See, e.g.*, Comment Letter to Robert Herz, Chairman, Financial Accounting Standards Board from Susan Schmidt Bies, Member of the Board of Governors of the Federal Reserve System, on Fair Value Measurements Exposure Draft, Oct. 4, 2004. Banks use amortized cost methods to value loan portfolios on their balance sheets. Office of the Chief Accountant, SEC: *Report and Recommendations Pursuant to Section 133 of the Emergency Economic Stabilization Act of 2008: Study on Mark-to-Market Accounting* (Dec. 30, 2008) at 27. As receiver for failed banks, the FDIC uses a similar method, "accreted value," to determine principal amounts of bank obligations.

These very short term debt instruments do not fluctuate in market value due to interest rate changes. It is also very unusual for the credit of an issuer to decline rapidly from prime quality to default in that short time period. Under amended SEC Rule 2a-7, Money Fund portfolios are very diversified among issuers, so there is limited credit exposure to any one issuer. As a result, within the strict investment constraints of SEC Rule 2a-7, the amortized cost of each portfolio security and of the portfolio as a whole closely tracks its market price, and the CNAV price per share closely tracks what the VNAV price per share would be using market pricing of the portfolio securities.

Unlike banks, U.S. Money Funds are required to use market values of individual securities to calculate a "shadow price" of their shares to test whether the use of amortized cost fairly approximates what VNAV would be using daily market values. If amortized cost does not track market value VNAV within less than half a cent per share, the board of directors of the U.S. Money Fund must determine what action to take, which may include movement to market values to calculate NAV and purchase and redemption prices of shares. This "shadow price" information is calculated at least weekly and that weekly data is reported to the SEC monthly, and is available to the public from the SEC or from the website of the Money Fund's sponsor. A review of these U.S. Money Fund shadow price calculations shows that CNAV using amortized cost closely tracks VNAV using market pricing. They are usually identical (even before rounding NAV to the nearest cent) and only occasionally deviate from one another by plus or minus a few one-hundredths of a cent.[46] To put this in perspective, a deviation of a hundredth of one percent is equal to a penny on $100 of U.S. Money Fund shares. It is not a material difference, and certainly not worth the programming expense that would be required to revise all of the automated systems used in commercial applications that need a predictable NAV to track short term liquidity. Unless the Money Fund is suddenly liquidated, even that small price deviation is not translated into actual losses, because the underlying portfolio investments mature in short order and are repaid at par, which returns shadow NAV to $1 per share. Due to the very high levels of liquid assets that U.S. Money Funds are required to hold under amended SEC Rule 2a-7, it is now even less likely that a U.S. Money Fund would need to sell portfolio assets before maturity to raise cash and recover less than par value.

Liquidity requirements have several benefits, including (i) the ability to meet shareholder redemption requests as they occur, including in difficult market conditions, and (ii) provides greater assurance that the use of amortized cost accounting is appropriate for the Money Fund by sharply reducing the possibility that portfolio assets will need to be sold at a loss to raise cash to meet investor redemptions.[47] An analysis of shadow price data demonstrates that U.S. Money Funds' $1 per share CNAV is not an accounting trick, but instead reflects the stable market values of the assets owned by U.S. Money Funds. A recent study of U.S. Money Fund shadow prices published by the Investment Company Institute ("ICI"), show that, due to the portfolio restrictions in SEC Rule 2a-7, Money Fund NAVs maintain their values in the face of credit events, interest rate changes and extraordinary market changes.[48] Even in September 2008, in the worst days of the financial crisis, average U.S.

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[46] ICI Research Report, Pricing of U.S. Money Market Funds (Jan. 2011).

[47] *See also*, Comments of Federated Investors (May 25, 2012) (copy attached) on IOSCO Consultation Report on Money Market Fund Systemic Risk Analysis and Reform Options (response to questions 3, 21).

[48] ICI Research Report, Pricing of U.S. Money Market Funds (Jan. 2011).

Money Fund shadow share prices stayed above 99.8 cents per share, and returned to an average NAV of 100.0000 cents within a very short period.[49]

The stability of Money Fund NAVs is driven by the stable market value of the underlying assets of Money Funds. This is why, in 2008, during the worst financial crisis since the 1930s, only one U.S. Money Fund "broke a buck" (the Reserve Primary Fund which returned to shareholders over 99 cents per dollar) over 800 U.S. Money Funds did not "break a buck," and the overwhelming majority of those did not require any sponsor support to maintain CNAV of $1 per share.

The 2010 amendments to SEC Rule 2a-7 have further removed price movements from the portfolios of assets owned by U.S. Money Funds. As of year-end 2010, for example, 50% of "prime" U.S. Money Funds' reported shadow prices are between 99.96 cents and 100.01 cents per share, 38% were between 100.01 and 100.10 cents per share, 6% were between 99.91 and 99.95 cents per share, and the remaining 6% had a shadow price between 99.80 and 99.90 cents per share. U.S. Money Fund "shadow prices" must move below 99.5 cents per share or above 100.5 cents per share to cause the Money Fund to "break a buck."[50] Nonetheless, U.S. and European Money Funds continue to warn investors that a Money Fund may not always be able to maintain a CNAV.

Nor is there a lack of transparency of the valuation methods used by U.S. Money Funds. Money Funds are also required to calculate the "shadow price" value of their shares, based on a mark-to-market valuation of portfolio assets, file that information with the SEC and publish it on the Money Fund's website. The use of the amortized cost method of accounting, and of rounding share prices to the nearest penny, is clearly disclosed to investors in the offering documents and reports provided to Money Fund investors. Moreover, if the CNAV of Money Fund shares calculated using the amortized cost method departs materially (0.50 cents per share or more) from the "shadow price" VNAV calculated using mark-to-market values, the Money Fund is required to notify the SEC and move to the VNAV in offering and redeeming shares with investors. These disclosures to every Money Fund investor, as well as the periodic public disclosure of the shadow NAV and portfolio holdings, make Money Funds perhaps the most thoroughly transparent investment available to the U.S. public.

From the perspective of a commercial user of Money Funds that needs to store short-term liquidity, the main purpose of using amortized cost to value portfolio assets is not to stabilize the value of Money Fund shares at $1 per share. That price stability is achieved by the very short term nature and high quality of the portfolio assets and rounding the NAV to the nearest penny per share, and would be the same $1 per share if mark-to-market accounting were used for valuing portfolio assets. The main purpose for using amortized cost in the commercial context is to allow the NAV of Money Fund shares to be anticipated at the beginning of the day, rather than known only after markets close, so that the share value can be used in a broad range of accounting applications that interface between the Money Fund, its transfer agent and the accounting systems of the various companies that use Money Funds to hold temporary liquidity, and can be redeemed on a same-day basis (T+0). This allows movement away from manual processing, facilitates same day processing of transactions, shortens settlement cycles, and helps reduce float balances and counterparty risk.

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[49] Money Fund Regulatory Changes Post Financial Crisis, 2011 ICI Money Market Funds Summit (May 16, 2011) (slides available on ICI website).

[50] *Id.*

Data Demonstrates that VNAV Does Not Stop Runs.

A primary part of the agenda of bankers and bank regulators in attempting to label Money Funds as "shadow banks" and force them into a bank-regulatory structure, is to prohibit Money Funds from using a constant NAV to price shares, and instead require Money Funds to use only a variable NAV. The premise behind this bankers' position is that Money Funds are subject to destabilizing "runs" because they use a CNAV, and that a VNAV would prevent runs. The bankers' premise, however, is not supported by the data.

During the financial crisis, VNAV money funds in Europe experienced investor withdrawals roughly equivalent to withdrawals from European CNAV money funds.[51] Similarly, in the U.S., Money Funds (which are analogous to Short-Term Money Market Funds under the CESR/ESMA Guidelines) are sometimes compared to ultra-short bond funds, which are mutual funds that invest in relatively short-term debt instruments, but do not use amortized cost accounting and must use a VNAV.

U.S. ultra-short bond funds are analogous to European Money Market Funds under the CESR/ESMA Guidelines, and similarly are required to use VNAV to price fund shares. U.S. ultra-short bond funds are not subject to the tight investment and credit quality restrictions, maturity limits or liquidity requirements that apply to U.S. Money Funds under SEC Rule 2a-7. The weighted average maturity of ultra-short bond funds is about 12 months, as compared to 60 days or less for a U.S. Money Fund.[52] Although they have a higher yield than U.S. Money Funds, ultra-short bond funds are not as popular with U.S. investors or with commercial users of Money Funds, with aggregate assets of only $36 billion in assets as of year-end 2010,[53] as compared to $2.6 trillion invested in U.S. Money Funds. Significantly, despite using VNAV to set share prices for purchases and redemptions, U.S. ultra-short bond funds faced investor redemptions in the Fall of 2008 at levels higher than those experienced by Money Funds.[54]

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[51] J. Fisch, & E. Roiter, "*A Floating NAV for Money Market Funds: Fix or Fantasy?*" (2011), *Scholarship at Penn Law*. Paper 390 at n.186-88, *available at* http://lsr.nellco.org/upenn_wps/390 ("Floating NAV money market funds suffered substantial redemptions during the credit crisis in 2008, leading more than a dozen of them to suspend redemptions temporarily and four of them to close altogether. French floating NAV money market funds lost about 40% of their assets during a three month period in the summer of 2007.") (citations omitted).

[52] J. Fisch, & E. Roiter, "*A Floating NAV for Money Market Funds: Fix or Fantasy?*" at n.183 (2011) ("The investment portfolios of ultra-short bond funds have longer weighted average maturities (around 12 months) than those of money market funds."), *Scholarship at Penn Law*. Paper 390, *available at* http://lsr.nellco.org/upenn_wps/390.

[53] Jonathan Burton, *A Place for Ultrashort?* Wall Street Journal (March 8, 2011) *available at* http://online.wsj.com/article/SB10001424052748703775704576162310225799344.html.

[54] *Id.* at n.181-85 ("While their share of assets pales in comparison to MMFs, ultra-short bond funds faced waves of redemptions comparable in respective magnitude to what MMFs faced. Indeed, contractions of ultra-short bond funds likely exacerbated the freeze in the short term credit markets. By the end of 2008, assets in these funds were 60% below their peak level in 2007." (*citing* In re David W. Baldt, SEC Admin Proc. File No. 3-13887, at 5-6, Apr. 21, 2011, *available at*www.sec.gov/litigation/aljdec/2011/id418rgm.pdf (detailing large redemptions from Schroder short term bond funds); Statement of the Investment Company Institute, SEC Open Meeting of the Investor Advisory Committee, May 10, 2010, at 4, *available at* www.ici.org/pdf/24289.pdf; HSBC Global Asset Management, Working Paper: *Run Risk at Money Funds* (Nov. 3, 2011).; ICI, Report of the Money Market Working Group (Mar. 17, 2009) at 105.

Whether VNAV prevents runs is an empirical question, and the data shows overwhelmingly that it does not. What stops a run is liquidity. The objective of reducing runs on Money Funds, and thereby reducing systemic risk, would not be met by requiring Money Funds to use VNAV.

U.S. Money Funds are Subject to Effective, Comprehensive SEC Regulation and Supervision that Provides a Test Case for Potential Regulatory Enhancements for European Money Funds

A former U.S. Federal Reserve Board Chairman recently testified before the U.S. Financial Crisis Inquiry Commission ("FCIC") that Money Funds were not regulated, and the FCIC summarized in its report that:

> money market funds had no capital or leverage standards.... The funds had to follow only regulations restricting the type of securities in which they could invest, the duration of those securities, and the diversification of their portfolios. These requirements were supposed to ensure that investors' shares would not diminish in value and would be available anytime-- important reassurances, but not the same as FDIC insurance.[55]

This line of thinking, which has been actively promoted by U.S. banking regulators, has found its way into page 5 of the Green Paper which suggests that Money Funds are part of a shadow banking system, accept "deposit-like funding" "without being subject to comparable constraints imposed by banking regulation and supervision", are engaged in a "'regulatory race to the bottom' for the banking system as a whole" and "avoid the regulation or supervision applied to regular banks...."

The truth is that Money Funds are ***comprehensively regulated*** by securities regulators under statutes and regulations that essentially require Money Funds to be capitalized entirely with equity and that preclude the use of leverage.

In the U.S., SEC regulations restricting the type of securities in which Money Funds can invest and their maturity and duration are a central reason why only two U.S. Money Funds have broken the buck in forty years of the industry's existence; and in those two cases investors got back the overwhelming majority of their investments relatively quickly. Similarly, European Money Funds are subject to comprehensive regulation under UCITS as revised in 2009 and the 2010 CESR/ESMA Guidelines. While there remains room for improvement, the most appropriate place to look for potential enhancements is not to the banking system on the theory that Money Funds are somehow analogous to banks, but to existing methods used by securities regulators and trade associations, including the SEC in the U.S., and the IMMFA in Europe, that have been tested over time on a large scale and shown to work for Money Funds.

The U.S. regulatory program governing Money Funds is not the same as government deposit insurance, but it has been far more effective than the deposit insurance and the U.S. bank regulatory scheme, both in protecting Money Funds and their customer/investors against insolvency and in protecting the government from having to bail them out. Money Funds do not represent a case of no regulation, but of profoundly successful, yet simple and extraordinarily elegant, regulation.

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[55] Final Report of the National Commission on the Causes of the Financial and Economic Crisis In the United States, January 2011, at 33.

The stability of U.S. Money Funds – especially when compared with U.S. banks – is due in large part to a regulatory system that provides for investor protection, active oversight, inspections and a competitive environment. The investment restrictions applicable to Money Funds are far more stringent than those that apply to banks in terms of duration, credit quality, and liquidity. In brief, U.S. Money Funds may invest in debt instruments in which a national bank may invest, including prime commercial paper, bank deposits, short-term U.S. government securities, and short-term municipal government securities.[56] However, they may not invest in many of the higher risk, less liquid and longer-term investments that national banks may own, such as medium and long-term government or corporate debt and most types of loans (*e.g.*, mortgages and consumer loans). In short, U.S. Money Fund investment portfolios are far less risky and far more liquid than those of U.S. banks. They need to be. Money Funds do not rely on a government guarantee to operate.

Money Funds are a type of mutual fund. U.S. Money Funds must register with the SEC as "investment companies" under the Investment Company Act, which subjects them to stringent regulatory, disclosure, and reporting provisions. The Investment Company Act and SEC regulation are the U.S. analog to the UCITS directive and EU-member state securities regulation. Money Funds must register offerings of their securities with the SEC and provide perpetually updated prospectuses to potential investors. They must also file periodic reports with the SEC and provide shareholders with annual and semi-annual reports, which must include financial data and a list of portfolio securities. In addition, the Investment Company Act governs virtually every aspect of a mutual fund's structure and operations, including its capital structure, investment activities, valuation of shares, the composition of the board, and the duties and independence of its directors. Mutual funds also are subject to extensive recordkeeping requirements and regular inspections.

U.S. Money Funds are subject to an additional SEC regulation: Rule 2a-7 under the Investment Company Act.[57] Money Funds seek to generate income and preserve investor funds by investing in short-term, high-quality debt. At the same time, they seek to maintain a constant NAV of $1 per share, so Rule 2a-7 permits a Money Fund to maintain a stable net asset value by using the "amortized cost" method of accounting.[58] This comes subject to the strict requirements of Rule 2a-7 to ensure that these funds are as stable and low risk as possible. Thus, a U.S. Money Fund must meet stringent portfolio liquidity, credit quality, maturity, and diversification requirements. These were strengthened by amendments in 2010 that were "designed to make money market funds more resilient to certain short-term market risks, and to provide greater protections for investors in a money market mutual fund that is unable to maintain a stable net asset value per share."[59]

European Money Funds are subject to similar requirements in many respects under the CESR/ESMA Guidelines. To the extent that additional enhancements to European Money Fund regulation are considered, the U.S. SEC's Rule 2a-7 presents a more workable set of requirements that have been successfully applied to Money Funds, and

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[56] 12 U.S.C. 24 (Seventh), 12 C.F.R. Part 1.

[57] *See* 17 C.F.R. § 270.2a-7.

[58] Under the "amortized cost" method of accounting, Money Funds value the securities in their portfolios at acquisition cost as adjusted for amortization of premium or accretion of discount rather than market value. *See* 17 C.F.R. § 270.2a-7(a)(2). The Rule also allows Money Funds to use the "penny-rounding" method of pricing, which permits rounding to one cent rather than one-tenth of a cent. 17 C.F.R. § 270.2a-7(a)(20). However, this method is seldom used because it does not eliminate daily "mark to market" accounting requirements.

[59] *See* Release No. IC-29132, 75 Fed. Reg. 10060 (Mar. 4, 2010).

that have been tested on a large scale over a period of years than bank-like requirements developed from scratch on the theory that Money Funds are "shadow banks."

SEC Rule 2a-7 and related SEC rules impose requirements on Money Funds in the following areas:

Liquidity. Under the 2010 amendments to SEC Rule 2a-7, a Money Fund is required to have a minimum percentage of its assets in highly liquid securities so that it can meet reasonably foreseeable shareholder redemptions.[60] Under new minimum daily liquidity requirements applicable to all taxable U.S. Money Funds, at least 10 percent of the assets in the fund must be in cash, U.S. Treasury securities, or securities that convert into cash (*e.g.*, mature) within one business day. In addition, under a new weekly requirement applicable to all Money Funds, at least 30 percent of assets must be in cash, U.S. Treasury securities, certain other government securities with remaining maturities of 60 days or less, or securities that convert into cash within five business days. No more than 5 percent of a fund's portfolio may be "illiquid" (i.e., cannot be sold or disposed of within seven days at carrying value). Prior to the 2010 amendments, Rule 2a-7 did not include any minimum liquidity requirements.

The minimum of 30% 7-day cash required to be held by U.S. Money Funds under revised rule SEC 2a-7 is double the percentage of assets redeemed from U.S. Money Funds during the worst week in mid-of the 2007-2009 Financial Crisis -- the week that Lehman Brothers failed and the Reserve Primary Fund "broke the buck." During the market turmoil in the Summer of 2011, involving European debt and U.S. government budget impasse, U.S. Money Funds had more than sufficient liquidity to meet substantial investor redemptions, without running into cash shortfalls or "breaking the buck."

Similar to SEC Rule 2a-7, Part VI of the IMMFA Code of Practice requires Money Funds managed by its members to maintain not less than 10% of portfolio assets in overnight liquid assets and not less than 20% of portfolio assets which mature within five business days. As under SEC Rule 2a-7, the IMMFA Code of Practice allows sovereign debt that the member determines is traded in a liquid market to be treated as meeting this standard, even though it may have a maturity date more than five business days away.

CESR/ESMA Guidelines require Short-Term Money Market Funds to take into account the liquidity considerations when making portfolio investments, and require stress-testing of portfolios taking into consideration liquidity needs, but currently do not include an express numerical requirement for minimum liquidity.

In considering areas for further enhancements to the current program of Money Fund regulation for Europe, the Rule 2a-7 liquidity requirements introduced in 2010 by the SEC, and those in place under the IMMFA Code of Practice, should be reviewed. This high level of cash provides two key protections for Money Funds during a crisis. First, what stops a run is cash.[61] When investors who request a redemption are quickly paid in full, no redemption queue forms, and investors do not panic and all suddenly demand to redeem shares at once. Second,

[60] Depending upon the volatility of the fund's cash flows (in particular shareholder redemptions), a fund may be required to maintain greater liquidity than would be required by the daily and weekly minimum liquidity requirements set forth in Rule 2a-7. *See* Release No. IC-29132, 75 Fed. Reg. 10060, 10074 (Mar. 4, 2010).

[61] A 2006 Paper in the FDIC Working Paper Series confirms that liquidity issues, rather than credit issues, are the triggers behind banking runs and panics. Kathleen McDill and Kevin Sheehan, *Sources of Historical Banking Panics: A Markov Switching Approach*, Working Paper 2006-01 (Nov. 2006) *available at* www.fdic.gov/bank/analytical/working/wp2006.../wp2006_01.pdf.

when a Money Fund has cash available from normal portfolio maturities to meet redemptions, it does not need to sell portfolio assets prior to maturity to raise cash (which is a key assumption that underpins the use of amortized cost accounting to value portfolio assets). This, in turn, protects the Money Fund from having to incur losses from sales of performing notes into an illiquid money market, and protects the money market from being locked up by a large amount of paper being sold into the market.

High Credit Quality. SEC Rule 2a-7 limits a Money Fund to investing in securities that are, at the time of their acquisition, "Eligible Securities." "Eligible Securities" include a security with a remaining maturity of 397 calendar days or less that has received a rating by two designated nationally recognized statistical rating organizations ("NRSROs") in one of the two highest short-term rating categories and unrated securities of comparable quality.[62] Under the 2010 amendments, 97% of a Money Fund's assets must be invested in "First Tier Securities."[63] Only 3 percent of its assets may be held in lower quality, "Second Tier Securities."[64] Previously, a Money Fund was permitted to invest 5% of its assets in "Second Tier Securities." In addition, a Money Fund may not invest more than ½ of 1 percent of its assets in "Second Tier Securities" issued by any one issuer (rather than the previous limit of the greater of 1 percent or $1 million). Under the 2010 amendments, a Money Fund also is prohibited from purchasing "Second Tier Securities" that mature in more than 45 days (rather than the previous limit of 397 days). As required by the DFA, the SEC has proposed the remove the references to NRSRO ratings and replace them with equivalent high credit quality determinations by the fund board or its designee.[65]

The CESR/ESMA Guidelines contain analogous credit quality and diversification requirements for portfolios of Short-Term Money Market Funds and Money Market Funds, and also require Money Funds to follow the money market instrument criteria specified in the 2009 UCITS Directive (Directive 2009/65/EC) in evaluating

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[62] Under Rule 2a-7(a)(12), if only one designated NRSRO has rated a security, it will be considered a rated security if it is rated within one of the rating agency's two highest short-term rating categories. Under certain conditions, a security that is subject to a guarantee or that has a demand feature that enhances its credit quality may also be deemed an "Eligible Security." In addition, an unrated security that is of comparable quality to a rated security also may qualify as an "Eligible Security."

[63] A "First Tier Security" means any Eligible Security that:

(i) is a Rated Security (as defined in Rule 2a-7) that has received a short-term rating from the requisite NRSROs in the highest short-term rating category for debt obligations (within which there may be sub-categories or gradations indicating relative standing);

(ii) is an unrated security that is of comparable quality to a security meeting the requirements for a rated security in (i) above, as determined by the fund's board of directors;

(iii) is a security issued by a registered investment company that is a Money Fund; or

(iv) is a Government Security.

The term "requisite NRSROs" is defined in Rule 2a-7(a)(23) to mean "(i) Any two Designated NRSROs that have issued a rating with respect to a security or class of debt obligations of an issuer; or (ii) If only one Designated NRSRO has issued a rating with respect to such security or class of debt obligations of an issuer at the time the fund acquires the security, that Designated NRSRO."

[64] Second Tier Securities are any Eligible Securities that are not First Tier Securities.

[65] SEC, *References to Credit Ratings in Certain Investment Company Act Rules and Forms*, 76 Fed. Reg. 12896 (Mar. 9, 2011).

permissible investments. Part VII of the IMMFA Code also imposes analogous credit quality standards on Money Funds operated by member organizations.

Short Maturity Limits. SEC Rule 2a-7 limits the exposure of Money Funds to risks like sudden interest rate movements by restricting the average maturity of portfolio investments. (This also helps a Money Fund maintain a constant NAV). Under the 2010 amendments to Rule 2a-7, the "weighted average maturity" of a Money Fund's portfolio is restricted to 60 days (compared to the previous limit of 90 days). In addition, the 2010 amendments limit the maximum "weighted average life" maturity of a fund's portfolio to 120 days. This restriction limits the fund's ability to invest in long-term floating rate securities. (Previously, there was no such restriction.) Thus, the "maturity mismatch" that Money Funds are subject to is far smaller than that faced by banks, which offer demand deposits, but make long-term loans.

The CESR/ESMA Guidelines contain analogous maturity requirements for portfolios of Short-Term Money Market Funds, but permit longer maturities in Money Market Funds. Under the CESR/ESMA Guidelines, the maximum weighted average maturity is 60 days, and maximum weighted average life is 120 days for Short Term Money Market Funds, with a maximum legal maturity of a portfolio asset is 397 days. For Money Market Funds, the maximum weighted average maturity is six months and weighted average life is twelve months, and the maximum legal maturity of a portfolio asset is two years.

Similarly, Part VII of the IMMFA Code of Practice sets a maximum weighted average maturity of 60 days, a maximum weighted average life of 120 days, and a maximum legal maturity date at 397 days, for Money Fund portfolio assets.

Periodic Stress Tests. Under the 2010 amendments to SEC Rule 2a-7, the board of directors of each Money Fund must adopt procedures providing for periodic stress testing of the funds' portfolio. Fund managers are required to examine a fund's ability to maintain a constant NAV per share based upon certain hypothetical events. These include a change in short-term interest rates, higher redemptions, a downgrade of or default on portfolio securities, and widening or narrowing of spreads between yields on an appropriate benchmark selected by the fund for overnight interest rates and commercial paper and other types of securities held by the fund. Previously, Money Funds were not subject to stress test requirements.

CESR/ESMA Guidelines require Short-Term Money Market Funds and Money Market Funds to stress-test their portfolios as part of their risk-management practices under Article 51 of the UCITS Directive. Section 24 of the IMMFA Code of Practice also requires member firms to perform periodic stress tests on their Money Funds at a frequency determined by the Money Fund's board of directors and appropriate under market conditions.

Repurchase Agreements. Money Funds generally invest a significant part of their assets in repurchase agreements. Many such agreements mature the following day and provide an immediate source of liquidity. In 2010, the SEC adopted two changes to Rule 2a-7 that strengthen the requirements for permitting a Money Fund to "look through" the repurchase issuer to the underlying collateral securities for diversification purposes. First, the SEC limited Money Funds to investing in repurchase agreements collateralized by cash items or government securities (in contrast to the prior requirement of highly rated securities) in order to obtain special treatment of those investments under the diversification provisions of Rule 2a–7. Second, the fund's board of directors must evaluate the creditworthiness of the counterparty. This amendment requires a fund adviser to determine that the counterparty is a creditworthy institution, separate and apart from the value of the collateral supporting the counterparty's obligation under the repurchase agreement. The 2010 amendments are designed to prevent losses caused by a counterparty's default.[66]

Part VII of the IMMFA Code of Practice sets maximum exposure limits to issuers and families of issuers, and repurchase agreement counterparties, held in a Money Fund portfolio.

Monthly Disclosure of Portfolio Information. Under the SEC 2010 amendments to U.S. Money Fund regulations, Money Funds must post their portfolio holdings each month on their websites and maintain this information for no less than six months after posting.[67] (Previously, Money Funds were not required to disclose information on their websites). Under the 2010 amendments, Money Funds also must now file monthly reports of portfolio holdings with the SEC,[68] which must include the market-based values of each portfolio security and the fund's "shadow" NAV.[69] The information becomes publicly available after 60 days.[70] (Previously, a Money Fund's "shadow" NAV was reported twice a year with a lag of 60 days).

Chapter IX and Annex 1 of UCITS require detailed disclosures to investors in investment companies (including Money Funds) regarding the portfolio of the fund on a semi-annual basis. CESR/ESMA Guidelines require additional disclosures regarding the risk profile and maturity of the Money Fund's portfolio. Part VIII of the IMMFA Code of Practice requires more frequent detailed disclosures by Money Funds regarding holdings, liquidity, maturity ranges, and credit quality of portfolio assets, in a standardized format.

It may be appropriate to consider whether to require more frequent and more detailed portfolio disclosure to European Money Fund investors, similar to that required by SEC rules in the U.S. and the IMMFA Code of Practice, including shadow price of shares, portfolio investment holdings, liquidity, and weighted average maturity of the portfolio.

Redemptions / Know Your Customer. Under a new requirement added to SEC Rule 2a-7 in 2010, Money Funds must hold securities that are sufficiently liquid to meet reasonably foreseeable redemptions. (Previously, there was no such U.S. requirement). To satisfy this new requirement, a Money Fund must adopt policies and procedures to identify the risk characteristics of large shareholders and anticipate the likelihood of large redemptions.[71] In practice, Federated and other large Money Fund advisers in the United States devote significant efforts to determining the anticipated investment horizons and redemption dates of large institutional shareholders, though communications with the investors or their intermediaries, as well as evaluation of their past purchase and redemption data, in order to assure appropriate liquidity will be available within the Money Funds. Depending upon the volatility of its cash flows, and in particular shareholder redemptions, this may require a fund

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[66] *See* Release No. IC-29132, 75 Fed. Reg. 10060, 10081 (Mar. 4, 2010).

[67] 17 C.F.R. § 270.2a-7(c)(12).

[68] 17 C.F.R. § 270.30b1-7(a).

[69] *See* Release No. IC-29132, 75 Fed. Reg. 10060, 10083 (Mar. 4, 2010).

[70] 17 C.F.R. § 270.30b1-7(b).

[71] *See* Release No. IC-29132, 75 Fed. Reg. 10060, 10075, n.198 and accompanying text (Mar. 4, 2010).

to maintain greater liquidity than would be required by the daily and weekly minimum liquidity requirements discussed above.[72]

It may be appropriate to consider whether to require a similar regime for European Money Funds.

Processing of Transactions. Under a new requirement adopted in 2010, SEC Rule 2a–7 requires a Money Fund to have the capacity to redeem and sell its securities at a price based on its current NAV. This requirement applies even if the fund's current net asset values does not correspond to the fund's stable net asset value or price per share. The new requirement minimizes operational difficulties in satisfying shareholder redemption requests and increases speed and efficiency if a fund breaks the buck. This change requires Money Funds to be able to process redemptions and thus provide liquidity if market prices of their portfolio assets decline, rather than defer share redemptions and corresponding sales of portfolio assets in order to avoid recognizing that decline in portfolio value. In essence, if market conditions dictate a movement to a floating NAV in order to process transactions and provide liquidity to redeeming shareholders, Rule 2a-7 requires Money Funds to do so. By forcing shareholder transactions to be processed at a price other than $1.00 when portfolio asset market conditions dictate, this rule change both enhances liquidity and addresses policy concerns over potential "runs" by shareholders seeking to redeem Money Fund shares ahead of unrecognized portfolio price declines or related deferrals by Money Funds of processing of redemptions.

Part V of the IMMFA Code of Practice requires its members to perform weekly mark-to-market shadow pricing of portfolios to validate the continued appropriateness of unit and portfolio values that are determined using amortized cost accounting. Part V also requires a process of escalation and board involvement and action when Money Fund unit values determined using mark-to-market portfolio valuations depart by 10 basis points, 20 basis points and 30 basis points from the amortized cost values.

Handling Default in a Portfolio Instrument. SEC Rule 2a-7 establishes procedures that a Money Fund must follow if a portfolio instrument is downgraded or a default or other event occurs with respect thereto. In some cases, a fund may be required to dispose of, or reduce its investments in, the issuers of such instruments.

The CESR/ESMA Guidelines specify that the manager of a Short-Term Money Market Fund must continue on an on-going basis to monitor the credit quality and rating of investments held in portfolio, and take corrective action in the best interests of the fund's unitholders if an investment no longer meetings the investment criteria specified by the Guidelines.

Shadow Pricing. To reduce the chance of a material deviation between the amortized cost value of a portfolio and its market-based value, SEC Rule 2a-7 requires Money Funds to "shadow price" the amortized cost net asset value of the fund's portfolio against its mark-to-market net asset value. If there is a deviation of more than ½ of 1 percent, the fund's board of directors must promptly consider what action, if any, it should take,[73] including whether the fund should discontinue using the amortized cost method of valuation and re-price the securities of the fund below (or above) $1.00 per share.[74] Regardless of the extent of the deviation, Rule 2a–7 obligates the

[72] *See* Release No. IC-29132, 75 Fed. Reg. 10060, 10074 (Mar. 4, 2010).

[73] 17 C.F.R. § 270.2a-7(c)(8)(ii)(B).

[74] *See* Release No. IC-29132, 75 Fed. Reg. 10060, 10061 (Mar. 4, 2010).

board of a Money Fund to take action whenever it believes any deviation may result in material dilution or other unfair results to investors.[75]

Under the CESR/ESMA Guidelines, only Short-Term Money Market Funds are permitted to use amortized cost and a CNAV. Other Money Market Funds must use mark-to-market portfolio valuations and a VNAV. The CESR/ESMA Guidelines do not contain clear guidance on use and publication of a shadow price based on mark-to-market valuations.

Part V of the IMMFA Code of Practice requires its members to perform weekly mark-to-market shadow pricing of portfolios to validate the continued appropriateness of unit and portfolio values that are determined using amortized cost accounting. Part V also requires a process of escalation and board involvement and action when Money Fund unit values determined using mark-to-market portfolio valuations depart by 10 basis points, 20 basis points and 30 basis points from the amortized cost values.

Enhancements of requirements under the CESR/ESMA Guidelines for calculation and publication of a shadow price for Short-Term Money Market Fund shares, analogous to the requirements of SEC rules and IMMFA Code of Practice, is a potential area for regulatory action that should be evaluated.

Diversification. In order to limit the exposure of a Money Fund to any one issuer or guarantor, Rule 2a-7 requires the fund's portfolio to be diversified with regard to both issuers of securities it acquires and guarantors of those securities.[76] Money Funds generally must limit their investments in the securities of any one issuer (other than Government securities) to no more than five percent of fund assets.[77] Money Funds also must generally limit their investments in securities subject to a demand feature or a guarantee to no more than ten percent of fund assets from any one provider.[78] As noted above, under the 2010 amendments to Rule 2a-7, a Money Fund may not invest more than ½ of 1 percent of its assets in "Second Tier Securities" issued by any one issuer.

Chapter VII of the UCITS imposes certain portfolio diversification requirements. The risk management requirements of the UCITS together with those contained in the CESR/ESMA Guidelines implicitly require a greater level of diversification than the numerical limits in Chapter VII.

Risk Management. Money Funds have robust risk management requirements, beginning with SEC Rule 2a-7's requirements that they limit holdings to the safest, most liquid and short-term investments and strict diversification requirements. Moreover, boards of Money Funds have substantial, detailed, and ongoing risk management responsibilities. For example, Money Fund boards must adopt written procedures regarding:

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[75] 17 C.F.R. § 270.2a-7(c)(8)(ii)(C).

[76] 17 C.F.R. § 270.2a-7(c)(4)(i).

[77] Rule 2a-7(c)(4)(i)(A). Rule 2a-7 includes a safe harbor that permits a taxable and national tax exempt fund to invest up to 25 percent of its assets in the first tier securities of a single issuer for a period of up to three business days after acquisition (but a fund may use this exception for only one issuer at a time). Rule 2a-7(c)(4)(i)(A).

[78] Rule 2a-7(c)(4)(iii). With respect to 25 percent of total assets, holdings of a demand feature or guarantee provider may exceed the 10 percent limit subject to certain conditions. *See* Rule 2a-7(c)(4)(iii)(A), (B), and (C). *See also* Rule 2a-7(a)(8) (definition of "demand feature") and (a)(15) (definition of "guarantee").

- Stabilization of NAV (which must take current market conditions, shadow pricing and consideration of material dilution and unfair results into account);
- Ongoing review of credit risks and demand features of portfolio holdings;
- Periodic review of decisions not to rely on demand features or guarantees in the determination of a portfolio security's quality, maturity or liquidity; and
- Periodic review of interest rate formulas for variable and floating rate securities in order to determine whether adjustments will reasonably value a security.

In order to ensure that boards are diligent and act in good faith, funds must also keep and maintain records of board consideration and actions taken in the discharge of their responsibilities. Management's decision-making processes must also be reflected in records such as whenever a security is determined to present a minimal credit risk, or when it makes a determination regarding deviations in amortized value and market value of securities and others.

Delegations of responsibilities by the board must be pursuant to written guidelines and procedures, and the Board must oversee the exercise of responsibilities. Even then, boards may not delegate certain functions, such as any decisions as to whether to continue to hold securities that are subject to default, or that are no longer eligible securities, or that no longer present minimal credit risk, or whose issuers have experienced an event of insolvency, or that have been downgraded under certain circumstances Nor may boards delegate their responsibility to consider action when shadow pricing results in a deviation of 1/2 of 1%, or to determine whether such deviations could result in dilution or unfairness to investors.

Article 51 of the UCITS Directive requires management companies of investment funds to have portfolio risk management processes in place. CESR/ESMA Guidelines further require that for Short-Term Money Market Funds and Money Market Funds, these portfolio risk management processes must include a prudent approach to the management of currency, credit, interest rate and liquidity risk, and a stress-testing regime.

SEC Rule 2a-7 provides that if a "First Tier Security" is downgraded to a "Second Tier Security" or the fund's adviser becomes aware that any unrated security or Second Tier Security has been downgraded, the board must reassess promptly whether the security continues to present minimal credit risks and must cause the fund to take actions that the board determines is in the best interests of the fund and its shareholders.[79] A reassessment is not required if the fund disposes of the security (or it matures) within five business days of the event.[80]

If securities accounting for 1/2 of 1% or more of a U.S. Money Fund's total assets default (other than an immaterial default unrelated to the issuer's financial condition) or become subject to certain events of insolvency, the fund must promptly notify the SEC and indicate the actions the Money Fund intends to take in response to such event.[81] If an affiliate of the fund purchases a security from the fund in reliance on Rule 17a-9, the SEC

[79] *See* 17 C.F.R. § 270.2a-7(c)(7)(i)(A).

[80] Where a Money Fund's investment adviser becomes aware that any unrated security or "Second Tier Security" held by the fund has, since the security was acquired by the fund, been given a rating by a Designated NRSRO below the Designated NRSRO's second highest short-term rating category, the board must be subsequently notified of the adviser's actions. *See* 17 C.F.R. § 270.2a-7(c)(7)(i)(B).

[81] *See* 17 C.F.R. § 270.2a-7(c)(7)(iii)(A).

must be notified of the identity of the security, its amortized cost, the sale price, and the reasons for such purchase.[82]

In the event that after giving effect to a rating downgrade, more than 2.5 percent of the U.S. Money Fund's total assets are invested in securities issued by or subject to demand features from a single institution that are "Second Tier Securities," the fund must reduce its investments in such securities to 2.5% or less of its total assets by exercising the demand features at the next exercise date(s), unless the fund's board finds that disposal of the portfolio security would not be in the best interests of the fund.[83]

When a portfolio security defaults (other than an immaterial default unrelated to the financial condition of the issuer), ceases to be an Eligible Security, has been determined to no longer present minimal credit risks, or certain events of insolvency occur with respect to the issuer of a portfolio security or the provider of any demand feature or guarantee of a portfolio security, the Money Fund is required to dispose of the security as soon as practicable consistent with achieving an orderly disposition of the security (by sale, exercise of a demand feature, or otherwise), unless the fund's board finds that disposal of the portfolio security would not be in the best interests of the fund.[84]

The CESR/ESMA Guidelines specify that the manager of a Short-Term Money Market Fund must continue on an on-going basis to monitor the credit quality and rating of investments held in portfolio, and take corrective action in the best interests of the fund's unitholders if an investment no longer meets the investment criteria specified by the Guidelines.

Fund Liquidation. SEC Rule 22e-3,[85] adopted in 2010, permits a U.S. Money Fund's board of directors to suspend redemptions and postpone payment of redemption proceeds if the fund is about to break the buck and the board decides to liquidate the fund. Previously, the fund board was required to obtain an order from the SEC before suspending redemptions. This amendment is designed to facilitate an orderly liquidation of fund assets in the event of a threatened run on the fund.[86] The SEC has broad powers under the Investment Company Act and other U.S. securities laws to oversee the liquidation of a Money Fund.

Part V of the IMMFA Code of Practice requires its members to perform weekly mark-to-market shadow pricing of portfolios to validate the continued appropriateness of unit and portfolio values that are determined using amortized cost accounting. Part V also requires a process of escalation and board involvement and action when Money Fund unit values determined using mark-to-market portfolio valuations depart by 10 basis points, 20 basis points and 30 basis points from the amortized cost values.

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[82] *See* 17 C.F.R. § 270.2a-7(c)(7)(iii)(B).

[83] *See* 17 C.F.R. § 270.2a-7(c)(7)(i)(C).

[84] *See* 17 C.F.R. § 270.2a-7(c)(7)(ii).

[85] *See* 17 C.F.R. § 270.22e-3.

[86] The rule permits a fund to suspend redemptions and payment of proceeds if (i) the fund's board, including a majority of disinterested directors, determines that the deviation between the fund's amortized cost price per share and the market-based net asset value per share may result in material dilution or other unfair results to investors, (ii) the board, including a majority of disinterested directors, irrevocably has approved the liquidation of the fund, and (iii) the fund, prior to suspending redemptions, notifies the SEC of its decision to liquidate and suspend redemptions.

One area to consider for possible enhancement of the existing European framework for Money Fund regulation is a more defined process for orderly wind-down and liquidation of a Short-Term Money Market Fund in the event it "breaks a buck."

Sponsor Support: Purchases by Sponsors or Other Affiliated Persons. Under the SEC's rules, affiliated persons are permitted, but not required, to purchase distressed assets from a Money Fund in order to protect the Money Fund from loss.[87] Conditions apply under the SEC rules to such affiliate purchases that are designed to protect the Money Fund from transactions that would disadvantage the fund.[88] The SEC rules also require the Money Fund to report all such purchases to the SEC. Notably, however, managers of U.S. Money Funds are prohibited from guaranteeing in advance that the share values will not decline,[89] but instead must disclose to investors that the shares are not guaranteed, and may lose value.[90] Any market expectation that sponsors will always provide support to Money Funds was dashed by the Reserve Primary Fund.

Explicit Disclosures to Investors that the Fund is Not Government Insured. U.S. Money Fund investors receive explicit disclosure that investments in Money Funds are not insured or guaranteed by the government. Item 4(b) of the SEC Form N-1A registration form that is used by open-end management investment companies to register under the Investment Company Act and to offer their shares under the Securities Act specifies that s a Money Fund prospectus must state:

> An investment in the Fund is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. Although the Fund seeks to preserve the value of your investment at $1.00 per share, it is possible to lose money by investing in the Fund.

In addition, if a Money Fund is advised by or sold through an insured depository institution, the above disclosure must be combined in a single statement with disclosure that an investment in the fund is not a deposit of the bank and is not insured or guaranteed by the FDIC or any other government agency.

The CESR/ESMA Guidelines require specific disclosures to investors in a Money Fund of the differences between a Money Fund investment and a bank deposit, and that the fund's objective to preserve capital is not a capital guarantee, as well as certain other disclosures regarding the risk profile and maturity of the Money Fund's portfolio.

Reforms Already Adopted For Money Funds By Securities Regulators

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[87] *See* 17 C.F.R. § 270.17a-9.

[88] Rule 17a–9 provides an exemption from Section 17(a) of the Investment Company Act to permit affiliated persons of a Money Fund to purchase distressed portfolio securities from the fund. Absent an SEC exemption, Section 17(a)(2) prohibits any affiliated person or promoter of or principal underwriter for a fund (or any affiliated person of such a person), acting as principal, from knowingly purchasing securities from the fund. Rule 17a–9 exempts certain purchases of securities from a Money Fund from Section 17(a), if the purchase price is equal to the greater of the security's amortized cost or market value (in each case, including accrued interest). *See* Release No. IC-29132, 75 Fed. Reg. 10060, 10087 (Mar. 4, 2010), at n. 365.

[89] *See* U.S. Investment Advisers Act § 206, 15 U.S.C. § 80b.

[90] Item 4(b) of the SEC Form N-1A; Federal Reserve Board, FDIC, OCC, OTS, Interagency Statement on Non-Deposit Investment Products (Feb. 1994).

Appropriately, after studying the lessons from the 2007-2009 financial crisis, the European Commission moved promptly and responsibly in 2009 to enhance the regulation of investment funds through revision of the UCITS Directive, which was followed in May 2010 by the adoption by the CESR (now ESMA) of Guidelines on European Money Market Funds which went into effect in 2011. As discussed above, the new requirements have significantly shortened the portfolio maturities of Short-Term Money Funds, enhanced portfolio credit quality and diversification requirements, imposed stress-testing requirements and additional investor disclosure requirements. These reforms are an important step forward that has significant enhanced the operations and stability of Money Funds. This is an on-going process among the securities regulators and trade associations of the Money Fund industry, and more workable reforms can and should be considered. The U.S. SEC has also adopted enhancements beyond those contained in the CESR/ESMA Guidelines, and those may appropriately be considered as potentially useful -- and tested -- further enhancements to the European program of Money Fund regulation.

Revisions to Money Fund Supervision Proved Effective in 2011 European Debt Crisis, US Budget Impasse

In 2010, the SEC acted decisively to enhance the stability and liquidity of U.S. Money Funds through amendments to SEC Rule 2a-7 and related rules and reporting forms. These changes have included a requirement to maintain liquidity sufficient to meet reasonably foreseeable redemptions, a requirement that taxable money market funds hold at least 10 percent of their assets in "daily liquid assets" and that all Money Funds hold at least 30 percent of their assets in "weekly liquid assets," and a new power for Money Funds to suspend redemptions in extreme circumstances, to ensure an orderly liquidation process. Most Money Funds in fact hold cash and near-cash items well above the 10% and 30% minimums. To put these ratios in perspective, Money Funds currently hold $2.6 trillion in assets. Of that amount, over $260 billion is in overnight cash and roughly $800 billion or more must have a maturity that permits it to be converted to cash within one week.

Since 2010, the SEC has also enhanced its methods and added staff to monitor Money Funds. Using data from the new Form N-MFP filings, the SEC has created a central database of U.S. Money Fund portfolio holdings. The database allows the SEC to analyze and sort reported data in a variety of ways, so that it can evaluate any U.S. Money Fund's overall maturity, diversification, credit quality, credit enhancements and liquidity. This database allows SEC officials to identify each U.S. Money Fund that holds a particular issuer's commercial paper. The SEC staff can also use reports of Money Funds to identify those that have experienced sudden growth in assets under management or high yields. Analysts within the SEC now sift through weekly portfolio data submitted each month electronically by all Money Funds, looking for risk. Using this data, the SEC Staff now follows up frequently with Money Fund managers, asking with detailed questions about reported data, trends in yields and portfolios, growth, repo counterparties, general market conditions and other issues, and for explanations of adverse trends, portfolio red flags and potentially risky investments.

The new liquidity requirement has proven effective. In 2011, at a time of extreme volatility in world markets caused by fear of major sovereign defaults and the potential for related contagion, Money Funds experienced dramatic shareholder redemptions in June and again in late July/early August. Investors reacted first to the Greek debt crisis and then to the U.S. federal budget deadlock. Money Funds handled massive redemption requests during both the Greek debt crisis and the U.S. federal debt ceiling impasse without disruptions. Much of the redemption activity was in short bursts around the key events of each financial episode. Yet no Money Fund broke a buck. None faltered or was unable to meet redemption requests. The key reforms adopted by the SEC in 2010, which shortened Money Fund maturities, increased cash holdings and portfolio diversification, and improved credit quality, worked exactly as intended

The European Commission should consider some of the additional reforms adopted in 2010 in the U.S. and required by the IFFMA Code of Practice, because they have proven very effective at maintaining the soundness of Money Funds through a difficult economic period. Of particular significance, these additional reforms include mandatory daily and weekly minimum liquidity rules and increased transparency about Money Fund portfolios and shadow prices of units.

A recent action by the U.S. Commodity Futures Trading Commission ("CFTC") confirmed that agency's positive view of the liquidity and stability of Money Funds. In recently adopted amendments to its regulations,[91] the CFTC retained Money Funds as a permitted investment under its Regulation 1.25, permitting unlimited investments in Money Funds that invest only in U.S. government securities (subject to limits on investments in smaller Money Funds). Regulation 1.25 is the principal CFTC rule establishing safeguards for the investment of customer segregated funds by futures commission merchants ("FCMs") and derivatives clearing organizations ("DCOs").[92] As the CFTC has stated, "[C]ustomer 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 DCOs and to enable investments to be quickly converted to cash at a predictable value in order to avoid systemic risk."[93] Regulation 1.25 therefore establishes a general prudential standard that all permitted investments be "consistent with the objectives of preserving principal and maintaining liquidity."[94] The CFTC noted that commenters on its original proposal to amend Regulation 1.25 stressed that Money Funds are safe, liquid investments and that only two funds in the 40-year history of Money Funds have failed to return $1 per share to investors.[95] Commenters also noted how enhancements to Rule 2a-7 have made Money Funds even safer and more prepared to withstand heavy redemption requests and have increased Money Fund transparency.[96] In permitting an FCM or DCO to invest all of its customer segregated funds in Treasury-only Money Funds, subject to limits applicable to smaller funds, the CFTC stated that it "agrees with commenters that since an FCM or DCO may invest all of its funds in Treasuries directly, an FCM or DCO therefore should be able to make the same investments indirectly" via a Money Fund.[97]

A similar endorsement of the efficacy of the SEC's amended Rule 2a-7 comes from the Office of the Comptroller of the Currency's ("OCC's") recent proposal to amend its rules governing bank "short term investment funds" ("STIFs") for fiduciary assets to conform more closely to Rule 2a-7.[98] As the OCC notes, a STIF is a bank-administered collective investment fund that, like Money Funds, "permits a bank to value the STIF's assets on an amortized cost basis, rather than at mark-to-market value,"[99] maintains a stable net asset value, and is deemed "a liquid, low risk investment."[100] The OCC's proposed amendments are intended to address a risk that STIFs and

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[91] *Investment of Customer Funds and Funds Held in an Account for Foreign Futures*, 76 Fed. Reg. 78776 (Dec. 19, 2011).

[92] 17 C.F.R. § 1.25.

[93] 76 Fed. Reg. at 78776

[94] 76 Fed. Reg. at 78776, citing 17 C.F.R. § 1.25(b).

[95] 76 Fed. Reg. at 78785.

[96] 76 Fed. Reg. at 78785-78786.

[97] 76 Fed. Reg. at 78785-78786.

[98] *Short-Term Investment Funds*, 77 Fed. Reg. 21057 (Apr. 9, 2012).

[99] 77 Fed. Reg. 21058.

[100] 77 Fed. Reg. 21058.

Money Funds share: "[w]hile fiduciary accounts participating in a STIF have an interest in the fund maintaining a stable [NAV], ultimately the participating interests remain subject to the risk of loss to a STIF's principal."[101] Thus, the OCC has proposed rule changes that correspond to those adopted by the SEC in 2010 for Money Funds.[102] As the bureau of the Department of the Treasury that is charged with the oversight of national banks and thrifts, the OCC's adoption of Rule 2a-7's pattern of Money Fund regulation illustrates how the SEC's approach has fostered the stability and utility of Money Funds as short-term investments.[103]

Conclusion

Money Funds are an important type of entity in the financial markets, and efficiently intermediate investor's shareholdings with short-term funding of governments, businesses and financial institutions. Money Funds have been successful by using a very simple, common sense approach, which permits investment only in short term, high quality money market instruments, and maintaining a very liquid investment portfolio sufficient to meet investor redemption requests out of normal cash flows from maturing portfolio investments.

Money Funds should not be labeled as a type of "shadow bank," and should not be subjected to a banking-style capital structure and regulatory program. Instead, Money Funds should continue to be treated as what they actually are -- highly liquid investment funds by which investor cash is pooled and invested in money market assets -- and regulated by securities regulators in a manner consistent with their actual structure and purpose.

Rather than imposing dramatic and potentially dislocative changes on the regulation of Money Funds by imposing bank-like capital structures and regulations, it would be more prudent to continue the careful fine-tuning of the European regulatory program for Money Funds developed by securities regulators that have included the revised UCITS Directive in 2009 and the CSER/ESMA Guidelines in 2010. There remain areas for further improvement in the regulation and supervision of Money Funds in Europe that are appropriate for consideration.

Most significantly, these include more specific requirements and standards for portfolio liquidity and a "know your investor" requirement tied to a Money Fund setting potentially higher minimum liquidity requirements based on anticipated redemptions, more specificity on portfolio diversification requirements, as well as increased risk

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[101] 77 Fed. Reg. 21058.

[102] 77 Fed. Reg. 21059, *citing* SEC, *Money Market Fund Reform,* 75 Fed. Reg. 10060 (Mar. 4, 2010). The OCC's proposal states that the new rules would differ from Rule 2a-7 "in certain respects" 77 Fed. Reg. 21059. In particular, bank STIFs under the proposal are subject to significantly less stringent liquidity requirements than Money Funds and would not be required to maintain overnight liquidity of 10% or more of total assets or 7-day liquidity of 30% or more of assets. Because liquidity is key both to preventing and resolving runs, and to obviating the need to sell portfolio assets before maturity to raise cash to make distributions, which thereby substantiates the appropriateness of the use of amortized cost accounting to value units, this is a particularly significant departure from Rule 2a-7.

[103] We note that bank collective investment funds operated under the OCC's Part 9.18 regulations have not previously been subject to risk-limiting standards similar to those contained in SEC Rule 2a-7, which can lead to substantial risks. For example, at the time of the Financial Crisis, a Federal Reserve member bank supervised by the Federal Reserve Bank of Boston operated a bank collective investment fund known as a "Limited Duration Bond Fund," that it marketed as a safe and diversified alternative to a Money Fund. That bank collective fund became "almost entirely invested in subprime residential mortgage-backed securities and derivatives that magnified its exposure to subprime securities," and not the diverse array of safe investments that it represented to its customers. Ultimately, the fund's value plummeted, and the sponsor bank paid $663 million to settle SEC fraud charges and investor claims (notwithstanding the supervisory authority of the Federal Reserve Bank of Boston, the SEC retains authority to pursue fraudulent misrepresentation under the general authority of Section 17 of the Securities Act of 1933). SEC Rel. No. 33-9107 (Feb. 4, 2010) (*available at* http://www.sec.gov/news/press/2010/2010-21.htm).

disclosure and transparency regarding portfolio assets and their current market values, publication of a "shadow NAV" using current market values of portfolio values, and a more thoroughly-defined process for moving from a stable CNAV to a floating VNAV in those very rare circumstances in which the Money Fund fails to maintain a stable net asset value per share. In addition, enhanced supervisory analysis and follow-up on Money Fund portfolio risk, particularly consideration of red flags such as unusual growth or portfolio returns, and portfolio exposure to particular issuers, may be in order.

These further enhancements to Money Fund Regulation were adopted by the U.S. SEC in 2010 after the Financial Crisis, and have shown the capacity to further stabilize share values, increase investor awareness, and stave off "runs" by shareholders of Money Funds. Serious consideration should be given to adopting additional standards for European Sort-Term Money Market Funds similar to those adopted in 2010 for U.S. Money Funds.

Respectfully submitted,

/s/

Gregory P. Dulski
Corporate Counsel

Appendix A
Questions from Green Paper

Questions:

a) Do you agree with the proposed definition of shadow banking?

No. The term "shadow bank" had a very different meaning in the past, but has been repurposed by some as a pejorative label to apply broadly to businesses that use significant leverage and are unregulated.

b) Do you agree with the preliminary list of shadow banking entities and activities? Should more entities and/or activities be analysed? If so, which ones?

No. Money Funds should not be included within the list of "Shadow Banks." Money Funds are not banks and do not operate in the shadows. Money Funds do not rely on deposits or other debt financing. Money Funds rely entirely on equity financing provided by shareholders, rather than debt or other forms of leverage provided by creditors and counterparties. Money Funds should not perform significant maturity or liquidity intermediation; instead the asset portfolio of Money Funds should be highly liquid, high credit quality, diversified, and very short term. In addition, Money Funds are far more transparent than banks.

Money Funds are, and should be, regulated on a comprehensive basis by national securities regulators in ways consistent with their structure and purposes, rather than regulated as a type of bank.

c) Do you agree that shadow banking can contribute positively to the financial system? Are there other beneficial aspects from these activities that should be retained and promoted in the future?

Federated agrees that non-bank firms, including Money Funds, can and do contribute positively to the financial system and the economy. We do not agree to the use of the term "shadow banking" to refer to Money Funds. Attempting to re-configure Money Funds into a bank regulatory model will damage Money Funds and all who rely upon them, make the economy and financial system less efficient, less robust, and more thoroughly dependent upon government support to maintain solvency.

d) Do you agree with the description of channels through which shadow banking activities are creating new risks or transferring them to other parts of the financial system?

Federated believes that Money Funds reduce risk in the financial system by increasing efficiency, reducing financing costs to government and business, and serving as a check upon the further growth of the largest "too big to fail" banks that depend upon a government safety net to maintain their solvency.

e) Should other channels be considered through which shadow banking activities are creating new risks or transferring them to other parts of the financial system?

Regulators should consider whether their efforts to regulate Money Funds under a banking model will increase systemic risk, increase borrowing costs to governments and businesses, decrease economic efficiency, lead to further growth in the largest "too big to fail" banks that rely on government support to maintain their solvency, and provide a further drag on economic growth and recovery.

f) Do you agree with the need for stricter monitoring and regulation of shadow banking entities and activities?

Federated supports consideration of further enhancements to the program of European Money Fund regulation by securities regulators, building upon methods that have proven effective in the U.S. and in European trade association requirements. We do not support imposition of untested and unworkable requirements based upon a bank regulatory model upon Money Funds.

g) Do you agree with the suggestions regarding identification and monitoring of the relevant entities and their activities? Do you think that the EU needs permanent processes for the collection and exchange of information on identification and supervisory practices between all EU supervisors, the Commission, the ECB and other central banks?

Federated supports regulatory efforts to regulate Money Funds under a securities regulatory framework. Federated supports sharing of information among regulators. Federated does not support efforts to label Money Funds are "shadow banks" or to regulate Money Funds under a bank regulatory framework.

h) Do you agree with the general principles for the supervision of shadow banking set out above?

Federated does not support the imposition of bank regulatory requirements upon Money Funds under the guise of regulation of "shadow banking."

i) Do you agree with the general principles for regulatory responses set out above?

Federated supports efforts to further enhance the regulation of Money Funds under a securities regulatory framework. We do not support the imposition of bank regulatory requirements upon Money Funds under the guise of regulation of "shadow banking."

j) What measures could be envisaged to ensure international consistency in the treatment of shadow banking and avoid global regulatory arbitrage?

Federated disagrees with the efforts to label the success of Money Funds as a result of "regulatory arbitrage." Money Funds are far more efficient than are banks as a result of far lower overhead and operating expenses, on the order of 200 - 300 basis points in lower costs per year for each dollar of balance sheet assets. Moreover, unlike banks, Money Funds are not dependent upon government support to maintain their solvency. The balance sheet of a Money Fund contains far less risk than that of a bank. Money Funds are successful because they invest prudently on a transparent basis in diverse pools of very liquid, short-term, high credit quality debt instruments.

k) What are your views on the current measures already taken at the EU level to deal with shadow banking issues?

Federated supports efforts to further enhance the regulation of Money Funds under a securities regulatory framework. We do not support the imposition of bank regulatory requirements upon Money Funds under the guise of regulation of "shadow banking."

Federated supports the inclusion of robust liquidity requirements for Money Funds, in addition to WAM, WAL, and other portfolio requirements. Liquidity requirements have several benefits, including (i) the ability to meet

Appendix B

History of Use of Historical Cost to Price Short-term Portfolio Securities.

Money Funds were not the first issuers to use amortized cost to calculate the value of their portfolio assets. Bank-sponsored short-term investment funds (STIFs) have a long history of use within bank trust departments, and have long been permitted by the federal bank regulators to use amortized cost of portfolio assets to calculate unit prices for purchases and redemptions.[104]

At the time of the creation of the first U.S. Money Funds in the early 1970s, NAVs for all U.S. mutual funds were determined much as they are today: by adding up the prices of the individual assets in the fund's portfolio, subtracting any liabilities and accrued expenses, and dividing by the number of shares outstanding. In valuing portfolio securities, mutual funds were directed to use current market prices if they are readily available, and otherwise to use "fair value" as determined in good faith by the board of directors.[105] In valuing very short-term high quality debt securities (for which there frequently were not current prices available from an active trading market), mutual fund directors in the early 1970s commonly determined that use of amortized cost was the best estimate of the fair value of those types of securities, in part because they planned to hold the short-term securities to maturity when the instruments would repay at par, rendering irrelevant any small short-term market price fluctuations.[106] If there was an error made in pricing a particular portfolio security, the "materiality" standard used to determine whether the shares needed to be repriced and shareholder accounts corrected was established for all mutual funds at 0.5% of NAV.[107] U.S. mutual funds in the early 1970s (and today) normally rounded NAVs to the nearest penny in determining share prices for purchases and redemptions.[108]

When the first U.S. Money Funds were created, it was accepted practice at mutual funds generally to (1) use amortized cost for valuing very short term debt instruments, (2) to round share prices to the nearest penny, and (3) to treat NAV as materially correct if it was accurate within 0.5 percent. Accordingly, when the first U.S. Money Funds were created, these were already widely accepted and broadly used accounting and valuation practices in the mutual fund industry, and the first Money Funds followed this normal valuation practice in calculating NAV.

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[104] 12 C.F.R. 9.18(b)(4)(ii)(B). Banks also use historical cost to value most assets on their balance sheets, and use amortized cost to value their loan portfolios, Office of the Chief Accountant, SEC: Report and Recommendations Pursuant to Section 133 of the Emergency Economic Stabilization Act of 2008: Study on Mark-to-Market Accounting (Dec. 30, 2008) at 27, even though bank loan portfolios have much longer average maturities and lower credit quality than Money Fund or STIF portfolios.

[105] 17 C.F.R. § 270.2a-4.

[106] J. Fisch, & E. Roiter, *A Floating NAV for Money Market Funds: Fix or Fantasy?* at 7, 8-11 (2011), *Scholarship at Penn Law.* Paper 390 (*available at* http://lsr.nellco.org/upenn_wps/390). *See also* SEC, Proposal Concerning Valuation of Short-Term Debt Instruments Owned by Registered Investment Companies Including Money Market Funds, 40 Fed. Reg. 18467 (Apr. 28, 1975); SEC, Valuation of Debt Instruments by Money Market Funds and Certain Other Open-End Investment Companies, 42 Fed. Reg. 28999 (May 31, 1977); SEC, Valuation of Debt Instruments and Computation of Current Price Per Share by Certain Open-End Investment Companies (Money Market Funds), 48 Fed. Reg. 32555 (Jul. 18, 1983).

[107] 17 C.F.R. § 2a-7(c)(ii)(8)(B); 17 C.F.R. § 22c-1.

[108] *See* J. Fisch, & E. Roiter, *A Floating NAV for Money Market Funds: Fix or Fantasy?,* at 7, 8-11 (2011), *Scholarship at Penn Law.* Paper 390,*available at* http://lsr.nellco.org/upenn_wps/390.

In 1975, the SEC became concerned that the NAV determined using amortized cost to value portfolios of a mutual funds whose assets consist primarily of short-term debt instruments (i.e. a Money Fund) might be materially different from the NAV of the fund using mark-to-market portfolio valuations and issued a release to address the question.[109] After considering public comments and studying this valuation issue for two years, the SEC in 1977 issued an interpretive release permitting the continued use of amortized cost to value short-term high quality debt instruments with 60 days or less of remaining maturity as an appropriate valuation method that reflects accurately the value of the asset.[110] As for valuation of portfolio assets with remaining maturities in excess of 60 days, the SEC in the 1977 interpretive release did not permit the fund to use amortized cost, without first obtaining an exemptive order permitting the use of amortized cost. The SEC, however, issued a series of exemptive orders to individual Money Funds setting out a series of conditions under which the funds that obtained the orders could use amortize cost to value portfolio assets with maturities in excess of 60 days.

Those old SEC order conditions were a set of standards designed to assure that amortized cost would be an appropriate reflection of the true value of the portfolio assets and NAVs calculated with amortized cost valuations would not materially depart from NAV determined using mark-to-market valuations. The SEC conducted extensive information gathering and analysis before adopting Rule 2a-7. The administrative process included extensive live hearings before an administrative law judge over a two-year period, expert testimony, written submissions and filings, input from the SEC Staff, the investment management industry, investors and the general public, and creation of a large administrative record.[111] The use of amortized cost accounting and the capital and asset structure of Money Funds were among the central issues considered in great detail in that process.

Eventually, in 1983, the conditions in the prior orders, the administrative rulemaking and hearing record, and SEC experience were distilled into a rule of general applicability for mutual funds that called themselves money market funds and permitting those that followed the rule to use the amortized cost method to value portfolio securities.[112] Rule 2a-7, adopted originally in 1983, has been amended on several occasions, most recently in 2010, to further refine its provisions based on experiences learned in the operation of Money Funds. Since 1983, however, SEC Rule 2a-7 has always made clear that shareholders do not have an unconditional right to redeem their shares at a stable price, that a Money Fund can use amortized cost "only so long as the [Money Fund's] board of directors believes that it fairly reflects the market-based net asset value per share" of the Money Fund, that if amortized cost does not reflect the fair value of a portfolio asset then amortized cost cannot be used for that asset, and if the mark to market value of the Money Fund's portfolio deviates by 0.50% or more from its amortized cost value (i.e. 1/2 cent per $1 share), then the board of the directors of the Money Fund must determine what action to take.

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[109] SEC, Proposal Concerning Valuation of Short-Term Debt Instruments Owned by Registered Investment Companies Including Money Market Funds, 40 Fed. Reg. 18467 (Apr. 28, 1975).

[110] *See* Valuation of Debt Instruments by Money Market Funds and Certain Other Open-End Investment Companies, 42 Fed. Reg. 28999 (May 31, 1977). For a general discussion of the development of the rules regarding calculation of the NAV of Money Funds, see J. Fisch, & E. Roiter, "*A Floating NAV for Money Market Funds: Fix or Fantasy?*" (2011), *Scholarship at Penn Law.* Paper 390 (*available at* http://lsr.nellco.org/upenn_wps/390).

[111] *In re Matter of Inter-Capital Liquid Asset Funds, Inc.* 18 SEC Docket 52 (Aug. 8, 1979).

[112] Rule 2a-7, 17 C.F.R. § 270.2a-7. SEC, Proposed Rule, Valuation of Debt Instruments and Computation of Current Price Per Share by Certain Open-End Investment Companies, 47 FR 5428 (Feb. 5, 1982); SEC, Final Rule, Valuation of Debt Instruments and Computation of Current Price Per Share by Certain Open-End Investment Companies (Money Market Funds), 48 Fed. Reg. 32555 (Jul. 18, 1983).

The 2010 amendments to SEC Rule 2a-7 also cap the maximum weighted average maturity of a Money Fund's portfolio at not more than 60 days.[113] (Notably, even under the SEC's restrictive valuation interpretations in place from 1977 until the adoption of Rule 2a-7 in 1983, use of amortized cost for valuing portfolio assets with remaining maturities of 60 days or less was permitted without an exemptive order or the conditions that came along with it).

Moreover, the SEC's 2010 amendments require U.S. Money Funds to hold overnight cash equal to at least 10% of fund assets and cash available within seven days equal to at least 30% of the fund's assets (and more if needed under the circumstances to meet anticipated needs). During the week of September 15, 2008, when Lehman Brothers filed for bankruptcy and the Reserve Primary Fund "broke the buck," the net outflow from all prime Money Funds was approximately 15% of aggregate prime Money Fund assets.[114] Holding this much cash greatly reduces the probability that a Money Fund would be required to sell portfolio assets at a loss to raise cash to fund redemptions, further assuring that use of amortized cost to value portfolio assets and calculate NAV per share will remain an appropriate and accurate way to calculate share values of Money Funds.

[113] 17 C.F.R. § 2a-7(c)(2)(ii); Money Market Fund Reform, 75 Fed. Reg. 10060, 10071-10072 (Mar. 4, 2010).

[114] SEC Chairman Mary L. Schapiro, Remarks at SIFMA's 2011 Annual Meeting, New York, New York (Nov. 7, 2011), *available at* www.sec.gov/news/speech/2011/spch110711mls.htm.

Appendix C

How Other Stable Value Products Maintain Stable Values.

Money Funds are one of several different financial products used in the United States to hold liquidity at a stable value. The others include bank deposits, bank trust department short-term investment funds (STIFs), repurchase agreements (repos), guaranteed investment contracts (GICs) and bank-sponsored collective funds that invest in GICs. GICs are issued primarily by insurance companies for set time periods and can be redeemed early under certain conditions specified in the contract, and are used as an investment alternative for pension assets.[115] GICs are marketed as an alternative to Money Funds and bank deposits.[116] Stable value GICs are essentially debt obligations of an insurance company, and GIC funds are investment funds (generally bank collective investment funds for pension assets) that invest in GICs. The value of the GICs themselves are dependent upon the solvency of the insurance company that issues them, the contractual rate and the terms and condition to full or partial redemption. Because GICs are not transferrable and do not trade in the secondary market, there generally are not true mark to market valuations available for GICs, and valuation of GICs and GIC funds is therefore often problematic.[117]

Repos are essentially a form of overnight or short-term financing secured by marketable securities. In form repos are a sale of the marketable security and a commitment to repurchase it at a set date and set price. The stable value of the repo obligation is based upon a combination of the creditworthiness of the counterparty and the market value and liquidity of the assets that are sold and repurchased.

STIFs are a type of bank common trust fund or collective investment fund that are sponsored and maintained by bank trust departments for fiduciary and pension assets. OCC rules authorize banks to operate STIFs as a type of stable value common trust fund.[118] STIFs use amortized cost to calculate portfolio values.[119] Bank STIFs are regulated and supervised by U.S. federal banking regulators, including the Federal Reserve and the U.S. Treasury Department's Office of the Comptroller of the Currency, are not regulated or supervised by the SEC and are not subject to SEC Rule 2a-7 like Money Funds.[120]

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[115] *See* American Institute of Certified Public Accountants, *Stable Value Investments available at* http://www.aicpa.org/InterestAreas/EmployeeBenefitPlanAuditQuality/Resources/AccountingandAuditingResourceCenters/Pages/StableValueInvestments.aspx.

[116] *See, e.g.*, Financial Web, *Guaranteed Investment Contracts*, *available at* http://web.finweb.com/investing/guaranteed-investment-contracts.html; Stable Value Contracts and GICs, *available at* http://www.lmstrategies.com/types~2.html.

[117] *See* OCC Interpretive Letter No. 716 (Dec. 21, 1995) (permitting valuation of benefit responsive GICs in bank collective fund at contract value rather than fair value); OCC Trust Interpretations No. 212 (Mar. 27, 1989), 265 (Mar. 19, 1992), 271 (Sept. 10, 1992) (requiring use of fair value).

[118] 12 C.F.R. § 9.18(b)(4)(ii)(B).

[119] *Compare* 12 C.F.R. § 9.18(b)(4)(ii)(B) (permitting up to 90 day weighted average maturity, not imposing minimum liquidity requirements and not specifying diversification or credit quality requirements for individual securities) with 17 C.F.R. § 270.2a-7 (maximum weighted average maturity of 60 days, and imposing very strict and specific liquidity, credit quality and diversification requirements).

[120] *See* 12 C.F.R. § 9.18; Investment Company Act §§ 3(a)(3), 3(c)(11).

Because they are subject to less stringent regulatory standards than SEC-regulated Money Funds, during the Financial Crisis, a large bank-operated, Federal Reserve-supervised STIF incurred substantial losses due to following portfolio practices involving far riskier and less liquid investments than are permitted for SEC-regulated Money Funds.[121] U.S. bank regulators recently have proposed to amend the rules governing bank collective STIFs to conform somewhat more closely to SEC requirements applicable to U.S. Money Funds in order to reduce the risk of a recurrence of the problem at bank-sponsored STIFs.[122]

Bank deposits are unconditional obligations of the bank to repay the depositor, either upon demand (demand deposits and some savings deposits) or at a date in the future (CDs and other time deposits). Deposits are debt obligations of the bank, rather than equity investments in the bank. The amount that a bank owes its depositors is fixed by contract and does not go up or down with the value of the bank's portfolio of loans and other assets. With the exception of securities trading portfolios that generally represent a relatively small percentage of bank assets, most bank portfolio assets are loans and other nonmarketable assets for which market price quotes are not readily available. Banks are required to disclose some fair valuation data on their assets, but it is very approximate and does not represent a full mark-to-market accounting of the bank's assets. The value of a bank's portfolio is determined primarily using historical cost accounting (subject to adjustments), rather than market valuations. Banks use amortized cost methods to account for loan portfolios on their balance sheets.[123] Banks do not calculate or report a mark to market "shadow price" for these loans or otherwise seek to gauge the degree to which the amortized cost at which loans are carried on the bank's balance sheet diverges from market values. Because the loans have durations well in excess of the maturity ranges of Money Fund portfolios and are lower in credit quality, the divergence between amortized cost of bank loan portfolios and current market values can be very large.

If a U.S. bank is unable to repay a deposit, or another debt obligation, when a demand for payment is made, the bank is insolvent and is taken over by the FDIC as receiver. A bank can become insolvent in either of two ways. A bank is insolvent if the accounting value of its assets is lower than the accounting value of its deposits and other liabilities. This is capital insolvency. Banks attempt to avoid this type of insolvency by holding enough equity capital to absorb loan losses and other downward accounting adjustments to their portfolio asset values so that the accounting values of the bank's assets exceed the bank's deposits and other liabilities. U.S. banks normally hold between four and ten percent capital against their assets on a leverage basis. Because capital is simply the difference between the value of the bank's assets (at historical cost) and its liabilities, and the historical cost of relatively long-term, high risk bank loans and other assets do not closely approximate current market values, it is hard to predict whether any particular level of capital is sufficient. When the FDIC liquidates a failed U.S. bank (unfortunately in the recent past, a very frequent occurrence), it generally finds that the market value of the bank's portfolio assets is substantially less than the accounting values at which those assets are carried on the bank's balance sheet, and consequently the true capital levels of the bank are far lower than indicated on the bank's

[121] *In the Matter of State Street Bank and Trust Company*, SEC Admin. Proceeding 3-13776, SEC Rel. 33-9107 (Feb. 4, 2010); *In the Matter of James P. Flannery et al.*, SEC Admin Proceeding No. 3-14081, SEC Rel. 33-9147 (Sept. 30, 2010).

[122] OCC, Short-Term Investment Funds, 77 Fed. Reg. 21057 (Apr. 9, 2012) (notice of proposed rulemaking).

[123] Office of the Chief Accountant, SEC: Report and Recommendations Pursuant to Section 133 of the Emergency Economic Stabilization Act of 2008: Study on Mark-to-Market Accounting (Dec. 30, 2008) at 27.

financial statements (and are often negative, requiring an infusion of cash from the FDIC to pay off the deposits).[124]

A bank can also become insolvent if it runs out of cash to repay depositors and other creditors when a demand for payment is made. This type of insolvency is liquidity insolvency. Banks attempt to avoid this type of insolvency by maintaining a sufficient amount of cash and liquid assets to pay anticipated demands, and by access to the central bank's lending window. Ultimately, if bank capital and liquidity are insufficient, it is the government safety net -- in the form of government-sponsored deposit insurance and access to cash from the central bank's lending window -- that allows a bank to repay deposits under most circumstances.

Thus, broadly speaking, there are two different ways in which providers of stable value investments seek to maintain their stable value.

Fund products, including Money Funds and bank STIFs, are equity interests in unleveraged investment pools that seek to maintain a stable value by investing in a diverse pool of high quality, liquid, short-term debt instruments whose market values remain stable throughout their short lives. Maintaining the stable value is not a function of the credit quality of the fund manager, but of the success of the fund manager in managing the pool of assets for diversity, duration, liquidity and credit quality. Regulations such as the CESR/ESMA Guidelines and SEC Rule 2a-7 which focus on those subjects are the means to address the issue of the stable value of the fund. In contrast to bank deposits and GICs, Money Funds seek to maintain a CNAV per share, but do not promise to investors that they will be able to do so, and fully disclose to investors that they might not be able to do so. [125]

In contrast to Money Funds, deposit and GIC products are debt instruments issued by companies that invest in a wide portfolio of marketable and unmarketable and generally non-transparent investments, for which the value of the stable value product is dependent upon the creditworthiness of the issuing bank or insurance company and any restrictions on redemption. In this case, regulatory capital levels and the other trappings of bank or insurance regulation are appropriate (subject to the caveat that bank and insurance capital levels are themselves derived from historical cost difference between assets and liabilities of the issuer and thus may not provide the amount of protection they might appear to based on balance sheet numbers), with the ultimate backstop being the federal government in the case of banks and state insurance pools, reinsurance and assessability of the industry for shared losses.

Applying bank-like capital standards to Money Funds is simply not an appropriate means to address maintaining stable value within the structure of fund products, any more than applying continuous mark-to-market accounting to bank assets and restricting bank balance sheets to the strictures of the CESR/ESMA Guidelines or SEC Rule 2a-7 would be an appropriate way to maintain the solvency of the banking industry.

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[124] FDIC, *Purchase and Assumption Transactions* (*available at* www.fdic.gov/bank/historical/reshandbook/ch3pas.pdf) ("Because asset values are generally overstated in a failing bank or thrift, the FDIC's ability to sell assets to an acquiring institution based on book value was limited.")

[125] J. Fisch, & E. Roiter, "*A Floating NAV for Money Market Funds: Fix or Fantasy?*" (2011), *Scholarship at Penn Law.* Paper 390 ("Nonetheless, money market funds differ fundamentally from banks. While a bank's obligation to pay its depositors in full is unconditional (as long as the bank is solvent), a money market fund's obligation to its shareholders is not."), *available at* http://lsr.nellco.org/upenn_wps/390.

Nor do Money Funds perform maturity or liquidity transformation, particularly when compared to the yardstick of the banking industry. All of the assets of a Money Fund are very short term and very liquid. This is in stark contrast to a bank, which holds a portfolio that consists primarily of loans and other non-standardized, non-traded credit instruments with much longer maturities, measured in months and years, very little liquidity, much higher credit risk, and very little transparency into the value of portfolio assets. Banks make long-term loans, and finance them primarily with short-term deposits. The right hand and left hand sides of a bank balance sheet look very different than those of a Money Fund. Despite the long-term nature of balance sheet assets and the absence of a current market benchmark for asset values, banks use amortized cost accounting for most portfolio assets, because banks assume that they will hold loans and most other balance sheet assets to maturity like a Money Fund. Banks are able to make this assumption because they are stabilized by liquidity provided when needed by the central bank and by government deposit insurance scheme which persuade depositors to remain in place in a crisis.

Finally, banks rely on financial leverage. Their balance sheets are financed almost entirely by borrowed funds, with only a small amount of equity. In contrast, Money Funds are financed entirely by equity capital, with little or no debt financing or creditors involved.[126] Money Funds do not fit the definition of "shadow bank" set out in the Green Paper.

The capital structure and regulatory scheme applied to banks is not appropriate for Money Funds because, unlike banks, Money Funds do not rely on funding from depositor/creditors and backstop liquidity government lenders and guarantors to operate, but on shareholders for funding and internal portfolio cash and short-term liquid assets for cash needs.

[126] UCITS Directive Article 83.

Appendix D

Performance Comparison of U.S. Money Funds to Bank Failures

In their early years, U.S. banks and their trade associations viewed Money Funds as competitors for retail business, and supported efforts to subject Money Funds to bank-like regulation and supervision.[127] U.S. policy makers, however, recognized that bank-like regulation would effectively kill off what has become not only an important investment choice for millions of individuals and institutions,[128] but also a highly efficient and essential mechanism to fund the needs of business and government borrowers in the short-term market.[129]

Moreover, U.S. Money Funds have enjoyed a superior safety record compared to U.S. insured depository institutions. Only two U.S. Money Funds have "broken the buck" and returned shareholders less than 100 cents on the dollar: the Community Bankers U.S. Government Fund, which in 1994 repaid its investors 96 cents on the

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[127] *See, e.g., Shooting at Money Market Funds*, Time, Mar. 23, 1981, *available at* http://www.time.com/time/magazine/article/0,9171,952946,00.html. The article states that that banking and savings institutions had "undoubtedly been hurt by the Money Funds" and that "banks and savings and loans have launched drives to bring them down....Last week the U.S. League of Savings Associations urged the Government to impose sharp restrictions on the money market funds and asked the Federal Savings and Loan Insurance Corporation to pledge up to $7 billion in low-cost loans." The article further notes that "Senate Banking Committee Chairman Jake Garn of Utah wants to prevent money market funds from offering check-writing privileges; Congressman James Leach of Iowa has introduced a bill that would diminish the funds' appeal by setting reserve requirements on them...The funds are also under heavy assault in several state legislatures." *See also* Karen W. Arenson, *Volcker Proposes Money Funds Be Subject to Rules on Reserves*, N.Y. TIMES, June 26, 1981 (noting that former Federal Reserve Chairman Paul A. Volcker testified before a Congressional subcommittee that money market funds should be subject to regulations that would make them more competitive with banking institutions and less attractive to investors. Mr. Volcker also testified that reserve requirements were a key part of monetary policy and because they could not be removed from banking institutions, also should apply to other investment vehicles); Beatson Wallace, *Money Funds Aren't Banks*, BOSTON GLOBE, May 21, 1981 (noting that "[m]oney market funds continue to be the whipping boy of the banking industry and the delight of the small sum investor.") The article explains that Treasury Secretary Donald T. Regan testified that "imposing new controls on our financial markets would be the wrong approach to assisting the thrift industry," but that nevertheless Senator Jake Garn "persists in his effort to curry support for legislation to curb the funds' check-writing feature and make the funds maintain a percent of their assets in a reserve account."

[128] *See, e.g., Competition and Conditions in the Financial System,* Hearings Before the Committee on Banking, Housing, and Urban Affairs, United States Senate, 97th Cong., 939 (1981) (statement of former SEC Commissioner John R. Evans, who testified that "we are very concerned with suggestions that legislation should be enacted which would impose bank-type regulation on money market funds to the detriment of [public] investors." Noting that "many depository institutions are having difficulty attracting savings during a period when money market funds are experiencing dramatic growth....We can understand why certain depository institutions might like their competitors to be restricted. We believe, however, that any consideration of legislation to impose bank-type regulatory burdens and limitations on money market funds should include an evaluation of the existing regulation of such funds, the present protection provided to investors, and the negative impact that such proposals would have on the millions of people who invest in money market funds." Further, "[i]t is the Commission's view that the harm to small investors, and the inconvenience to large investors, which could result from the imposition of bank-type regulations on money market funds may not be significantly offset by any benefit to banks and thrift institutions."

[129] *See* Phillip R. Mack, *Recent Trends in the Mutual Fund Industry,* 79 Fed. Reserve Bull. 1001 (1993), *available at* http://findarticles.com/p/articles/mi_m4126/is_n11_v79/ai_14714669/pg_5/?tag=content;col1, stating that "[m]oney market mutual funds grew rapidly in the late 1970s and early 1980s, when interest rates on money market instruments exceeded regulatory ceilings that applied to depository institutions. Flows from depositories to money funds supported expansion of the commercial paper market, an important alternative to bank loans for businesses."

dollar,[130] and the Reserve Primary Fund, which was forced to liquidate in September 2008 as a result of a run triggered by Lehman's bankruptcy and the fund's holdings of Lehman commercial paper. The Reserve Primary Fund has returned to shareholders more than 99 cents on the dollar.[131] Significantly, no U.S. government funds were used to bail out these Money Funds' shareholders.

U.S. Money Funds achieved this success under the regulation and oversight of the SEC and its Division of Investment Management. At the core of this regulatory program is SEC Rule 2a-7, which in eleven pages imposes sound principals that are the secret of the stability and solvency of Money Funds: invest only in very short-term, high quality, marketable debt instruments in a diversified manner, and do not use any leverage.

In comparison, U.S. regulation of banks involves four (formerly five) federal regulators and over fifty regulators in states and other districts. The federal agencies alone require over 26,000 full-time employees.[132] The U.S. federal banking code – Title 12 of the United States Code and Title 12 of the Code of Federal Regulations – totals fourteen volumes and many thousands of pages of requirements and prohibitions. Yet, during the 40 years since the launch of the first Money Fund – a period during which the Money Fund industry experienced exactly two instances in which a Money Fund failed to return 100% of principal invested to shareholders (in one case returning 96% of principal and in the other over 99%) – over 2,800 U.S. depository institutions have failed, and an additional 592 were the subject of "assistance transactions" in which the government injected capital to keep them afloat.[133] From 1971 through May 2012, total estimated U.S. FDIC losses incurred in connection with failed banks or assistance transactions amount to over USD $188 billion.[134]

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[130] The fund had only institutional investors, so individual investors were not directly harmed. *See* ICI Money Market Working Group Report, at 39, *available at* www.ici.org/pdf/ppr_09_mmwg.pdf. *See* Saul S. Cohen, *The Challenge of Derivatives*, 63 Fordham L. Rev. 1993, 1995 n.15 (1995) (internal citations omitted).

[131] *See* Press Release, *Reserve Primary Fund to Distribute $215 Million* (July 15, 2010), *available at* http://www.reservefunds.com/pdfs/Primary%20Distribution_71510.pdf; *see also* SEC Press Release: *Reserve Primary Fund Distributes Assets to Investors* (Jan. 29, 2010), *available at* http://www.sec.gov/news/press/2010/2010-16.htm.

[132] FDIC 2009 Annual Report; FRB 2009 Annual Report; OCC 2009 Annual Report; OTS 2009 Annual Report.

[133] FDIC Database of Failures and Assistance Transactions, *available at* http://www2.fdic.gov/hsob/SelectRpt.asp?EntryTyp=30.

[134] FDIC Database of Failures and Assistance Transactions, *available at* http://www2.fdic.gov/hsob/SelectRpt.asp?EntryTyp=30.

shareholder redemption requests as they occur, including in difficult market conditions, and (ii) provides greater assurance that the use of amortized cost accounting is appropriate for the Money Fund by sharply reducing the possibility that portfolio assets will need to be sold at a loss to raise cash to meet investor redemptions. Federated believes that it is appropriate to establish a floor for overnight liquid assets, as well as for 7-day liquid assets, but also to require the Money Fund to assess likely investor redemptions and hold higher levels of liquidity to meet anticipated redemptions and to address market conditions. Federated believes that a central challenge facing Money Funds globally is the ability to address shareholder redemptions, and that this is addressed only by maintaining robust levels of near-term liquidity.

l) Do you agree with the analysis of the issues currently covered by the five key areas where the Commission is further investigating options?

Federated supports efforts to further enhance the regulation of Money Funds under a securities regulatory framework. We do not support the imposition of bank regulatory requirements upon Money Funds under the guise of regulation of "shadow banking."

n) What modifications to the current EU regulatory framework, if any, would be necessary properly to address the risks and issues outlined above?

Federated supports efforts to further enhance the regulation of Money Funds under a securities regulatory framework. Attention to additional safeguards that have been implemented in trade association practice codes, and in the U.S. as part of the SEC's 2010 Amendments, serve as models for potential further enhancements to the European program of Money Fund regulation. More specifically, potential enhancements include (i) more specific requirements for portfolio liquidity including a "know your investor" requirement, (ii) more specificity on portfolio diversification requirements, (iii) increased transparency on portfolio assets and their current market values, and (iv) a more defined process for moving from a constant net asset value (C-NAV) to a variable net asset value (V-NAV) in those unusual circumstances when such a change is needed due to economic conditions. In addition, enhanced supervisory analysis and follow-up on Money Fund portfolio risk, particularly consideration of red flags such as unusual growth or portfolio returns, and portfolio exposure to particular issuers, may be in order. We do not support the imposition of bank regulatory requirements upon Money Funds under the guise of regulation of "shadow banking."

o) What other measures, such as increased monitoring or non-binding measures should be considered?

Federated supports efforts to further enhance the regulation of Money Funds under a securities regulatory framework. We do not support the imposition of bank regulatory requirements upon Money Funds under the guise of regulation of "shadow banking."

In Federated's view, the term Money Fund should be limited to funds that meet stringent requirements for portfolio credit quality, diversification, very short maturity and liquidity that are appropriate to maintaining a constant value. For example, U.S. ultra-short bond funds should not be considered Money Funds and European Money Funds that are not "short term" Money Funds under the CSER/ESMA Guidelines, in Federated's view, should not be brought within the definition of Money Market Fund. To do so muddles both investor understanding of the product and the policy debate over regulation of Money Funds.

As noted above in our general response, we believe that the cumulative effect of the 2010 Rule Amendments has been to improve the safety and liquidity of Money Funds and that the global Money Fund industry would be well served to adopted similar reforms, specifically relating to (i) more specific requirements for portfolio liquidity including a "know your investor" requirement, (ii) more specificity on portfolio diversification requirements, (iii) increased transparency on portfolio assets and their current market values, and (iv) a more defined process for moving from a constant net asset value (C-NAV) to a variable net asset value (V-NAV) in those unusual circumstances when such a change is needed due to economic conditions. In addition, enhanced supervisory analysis and follow-up on Money Fund portfolio risk, particularly consideration of red flags such as unusual growth or portfolio returns, and portfolio exposure to particular issuers, may be in order. Further enhancement of transparency to subaccounts would be beneficial.