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March 25, 2011

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

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

Dear Ms. Murphy:

We are writing to address certain proposals made in three comment letters regarding the President's Working Group on Financial Markets' (the "PWG") study of possible money market fund reforms (the "PWG Report").[1] Although Federated Investors, Inc. ("Federated") has already commented on the proposals made in the PWG Report and by the Squam Lake Group,[2] we consider it important to point out some critical errors made in their analysis of money market funds and problems with the Squam Lake Group's proposal in particular. We realize that while these letters were prepared by distinguished public servants and academics, the authors are not familiar with the management and operation of money market funds. Their lack of familiarity with these matters has led them astray, both in terms of their assessment of the potential for systemic risk and in their proposals for reform.

We will try not to reiterate points made in our previous letters. Our first letter explains, among other matters, why the proposal to eliminate money markets (by forcing them to "float" their share price) would be unwarranted and detrimental to investors, the capital markets and the U.S. economy as a whole.[3] Our second letter explains the adverse implications of encouraging shareholder dependence on managers providing financial support to their funds, as proposed by the Squam Lake Group. This letter will identify some of the errors made by the commenters in the arguments supporting their proposed reforms.

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[1] The PWG Report was published for comment in Release No. IC-29497, President's Working Group Report on Money Market Funds (Nov. 3, 2010), available at http://www.sec.gov/rules/other/2010/ic-29497.pdf. The three comment letters are from René M. Stulz, Squam Lake Group, available at http://www.sec.gov/comments/4-619/4619-57.pdf; Paul A. Volcker, available at http://www.sec.gov/comments/4-619/4619-79.pdf; and the Shadow Financial Regulatory Committee, available at http://www.sec.gov/comments/4-619/4619-81.pdf.

[2] Our prior comment letters are available at http://www.sec.gov/comments/4-619/4619-41.pdf and http://www.sec.gov/comments/4-619/4619-82.pdf.

[3] Presumably the Squam Lake Group did not have an opportunity to read this letter before filing theirs. Otherwise they would have "seen [an] analysis of the value of these benefits to money market fund investors [which Federated conservatively estimated at $500 billion] relative to the cost to the public of the associated systemic risk [of which there have been none to date]."

I. MONEY MARKET FUNDS ARE WELL SUPERVISED BY THE COMMISSION AND BY THEIR DIRECTORS

One of the commenters characterized money market funds as "unsupervised." There is no basis for this assertion. As the Commission knows, it carefully supervises money market fund and other investment companies. Moreover, the Commission has substantially increased its supervision of money market funds by requiring monthly reports of detailed portfolio information on Form N-MFP. As noted in our previous comment letter, the Commission has shown demonstrably more success in its supervision of money market funds than any other regulator has shown in its supervision of banks.

Money market funds are also supervised by their boards of directors, which normally consist of at least a majority and frequently (as in the case of Federated's funds) a super majority of directors who are independent of the fund's manager. From the first exemptive orders permitting funds to maintain a stable price, the Commission has required "the money market fund's board of directors, as a particular responsibility within the overall duty of care owed to its shareholders, [to] establish written procedures reasonably designed, taking into account current market conditions and the money market fund's investment objectives, to stabilize the money market fund's [share price]." (*See*, Rule 2a-7(c)(8) and (9)) The Commission also requires the directors to exercise their business judgment if they believe that this deviation will result in material dilution or other unfair results, or if the deviation exceeds half a cent. The recent amendments to Rule 2a-7 have further strengthened board supervision by requiring that funds conduct regular stress tests and report the results to their directors.

Perhaps the commenter meant "little or no … supervision" by the Board of Governors of the Federal Reserve. There is no reason to assume, however, that such additional supervision is warranted, and the commenter does not offer any justification for Fed supervision.

II. THE TREASURY'S TEMPORARY GUARANTEE DID NOT CREATE A MORAL HAZARD

All three commenters express concern that the Treasury's Temporary Money Market Fund Guarantee Program has created a moral hazard. According to the Squam Lake Group, "If money market fund managers believe that such guarantees will be forthcoming in response to any systemic events, they will have incentives to take greater risks than is prudent from a systemic perspective." They also speculate that shareholders will invest in money market funds regardless of their risks, confident of government protection.

The possibility of another Temporary Guarantee Program will not encourage money market fund managers to take such risks or investors to accept them. First, the temporary guarantee was extended only to those funds that had not already been forced to drop their share price below $1.00 (also known as "breaking a dollar"). It did not protect shareholders in the Reserve Primary Fund, who were forced to bear the losses incurred on the fund's investments in Lehman Brothers. Therefore, the Temporary Guarantee Program did not establish a precedent for federal protection of shareholders in funds that take imprudent risks.

Second, the Temporary Guarantee Program required the liquidation of a fund before guarantee payments would be made to its shareholders. Thus, a manager who took inappropriate risks based on a belief “that such guarantees will be forthcoming” would still find itself without any funds to manage if its funds broke a dollar due to excessive risk taking. Being put out of the business of managing money market funds should be an adequate deterrent to any theoretical moral hazard that the prospect of federal protection might otherwise generate.

Third, the Treasury only guaranteed shareholder balances as of a certain date, so the prospect of federal protection did not attract investments in the funds. Finally, as noted by the Squam Lake Group, the Emergency Economic Stabilization Act of 2008 prohibits the Treasury from reestablishing the Temporary Guarantee Program. Money market fund managers and shareholders therefore have no basis for believing “that such guarantees will be forthcoming.”

III. THE HISTORICAL BEHAVIOR OF SHAREHOLDERS DOES NOT SUPPORT THE CLAIM THAT THEY POSE SYSTEMIC RISKS

All three commenters state or imply that shareholders will “run” from a money market fund in an attempt to recover their investment before the fund breaks a dollar. They claim that this creates a systemic risk to the financial system, insofar as the threat of breaking a dollar could trigger massive redemptions from money market funds, which would in turn force funds to engage in a “fire sale” of their holdings and to stop providing short-term financing to the government, financial institutions and corporations. As evidence of this risk, they cite the large-scale redemptions from prime money market funds that occurred in the wake of the Reserve Primary Fund breaking a dollar.

This “run on the funds” scenario presumes that there is some time between an event triggering the redemptions and the fund breaking a dollar. However, the Moody’s report cited by two of the commenters[4] belies this presumption. Of the sixteen events identified in the report[5] as prompting manager support, twelve were isolated credit events. Such credit events are, by their nature, unanticipated (otherwise the funds would not be holding the securities when they defaulted). As a result, these events produce sudden decreases in the funds’ shadow prices that require an immediate response from the funds’ manager. In other words, in the absence of manager support, an adverse credit event should cause a money market fund to break a dollar immediately, without providing its shareholders with an opportunity to redeem in advance of the event.[6] “Running” will not protect money market fund shareholders from the consequences of an isolated credit event, so it is not surprising that none of these events triggered wide-scale redemptions. We must therefore look to other events for evidence of shareholders propensity to run from troubled money market funds.

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4 “Sponsor Report to Key Money Market Funds,” by Henry Shilling, Moody’s Investor Service, August 9, 2010.

5 Moody’s combines support provided for distressed structured investment vehicles and support provided after the Lehman Brothers bankruptcy, perhaps because it could not obtain separate financial information regarding the cost of this support. These were discrete events, however, and will be treated so for purposes of analysis.

6 The decision of the Reserve Primary Fund’s board of directors to allow the fund to continue operating for nearly two days after the Lehman Brothers bankruptcy without financial support is anomalous and may have been based on incorrect information. Federated has advocated reforms (such as temporary suspensions of redemptions) intended to prevent the recurrence of such errors.

A. 1980—Salomon Brothers

Of the remaining events, the first was a "liquidity" event in 1980 that required Salomon Brothers to support a fund. We have only anecdotal information about this event, but it was clearly an isolated occurrence with no systemic ramifications for the financial system.

B. 1994—"Hybrid" Adjustable Rate Securities and Orange County

The second series of events, which occurred in 1994, involved sustained interest rate increases and culminated in the bankruptcy of Orange County. During 1994 the Federal Reserve doubled the targeted Federal Funds rate from 3% to 6%, after leaving the target unchanged for almost two years. According to the Moody's report, managers purchased "hybrid" adjustable rate securities from 42 funds during the period to support their net asset values. These hybrid securities were subject to interest rate adjustments that increased their sensitivity to changes in market rates, so the securities fell in value and became illiquid as rates increased. One manager could not afford to acquire these hybrid securities and, in September, its U.S. Government Money Market Fund became the first fund to break a dollar. Finally, in December, losses on hybrid securities and derivatives forced Orange County into bankruptcy, prompting managers to provide support to an additional 37 prime and tax-exempt money market funds.

If the commenters' analysis of shareholder behavior were correct, we should have seen massive redemptions from money market funds at some point during 1994—when interest rate increases pushed the funds' shadow prices below a dollar, some funds needed support to maintain a stable price, one fund broke a dollar, and investors (particularly institutional investors) expected further rate increases. This was not the case, however, as both prime and tax-exempt funds ended 1994 with more assets than they began.[7] While net flows were volatile during the year (with net outflows in five of the twelve months, as might be expected when fund yields are lagging interest rate increases), the magnitudes of the monthly outflows (as a percentage of total assets) were smaller than those experienced during the two previous years, during which there were no events requiring managers to support their funds. For example, prime fund net outflows in December 1993 were much higher (6.5% of assets) than they were in any month in 1994 (February, the month with the highest net outflow, was only 3.2% of assets). The net outflow from tax-exempt funds in December 1994 (4.3% of assets) was not significantly more than the outflow in December 1993 (3.5% of assets). Thus, the events of 1994 cannot be squared with the commenters' analysis of why shareholders "run" from money market funds.

C. 2007—Structured Investment Vehicles ("SIVs")

The third set of events occurred in August and September 2007, when commercial paper issued by several SIVs either defaulted or had their maturities extended. Unlike earlier credit events, these extensions and defaults were not isolated incidents. Concerns about the liquidity structure of these vehicles led investors to stop purchasing any commercial paper issued by a

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[7] Our flow analysis is derived from information obtained from the Investment Company Institute. According to this data, prime fund assets increased from $313 billion at the end of 1993 to $353 billion at the end of 1994 and tax-exempt fund assets increased from $103 billion to $110 billion.

SIV, even if it was not in danger of defaulting. Investors also curtailed purchases of other types of asset-backed commercial paper, even if the special purpose entity issuing the commercial paper had adequate backup liquidity.

At the time, asset-backed commercial paper was widely held by prime money market funds and many funds held commercial paper issued by SIVs. Although only a subset of these funds held extended or defaulted commercial paper, the media was filled with reports about managers providing support to these funds. The press also reported on “money fund like” investment vehicles that had suspended redemptions, liquidated or could no longer maintain a stable value. Early reports sometimes mischaracterized these other vehicles as money market funds.

According to the commenters, shareholders should have fled from money market funds during this period. Depressed prices for asset-backed commercial paper reduced the shadow price of most prime funds below a dollar. (Although, according to an ICI Study, the shadow price of most prime funds was probably not even a tenth of a cent below $1.00.)[8] The commenters believe that, under such circumstances, shareholders would redeem rather than risk being caught in a fund that broke a dollar due to a default that the manager might not support. Prime funds experienced net *inflows*, however, which strengthened throughout the period. Net inflows in August 2007 were 1.4% of total assets, increasing to 2.7% in September and 4.3% in October. Thus, the commenters’ analysis cannot account for shareholder behavior following these events.

D. Lehman Brothers and The Reserve Primary Fund

The final set of events was the Lehman Brothers bankruptcy and the Reserve Primary Fund breaking a dollar in September 2008. This did trigger wholesale redemptions that led to federal intervention. The critical question is why shareholders responded differently to these events than they did in 1994 or late 2007. Federated believes that this is a question worthy of academic study, and that it would be worthwhile to ask investors why they redeemed from other funds in the wake of the Reserve Primary Fund breaking a dollar, rather than speculating about their motivations. In the absence of such direct evidence, however, we believe that the already existing lack of liquidity and extraordinary level of uncertainty in the market were the critical factors leading to the run in 2008.

As we have noted, most of the other events identified in the Moody’s report were isolated instances that affected a fixed number of funds. The support provided by their managers alleviated shareholder concerns because shareholders did not anticipate that other defaults were imminent. Even in 1994, investors could be confident that, so long as managers removed any hybrid securities from their money market funds, the Federal Reserve’s policy of raising interest rates would not cause their funds to break a dollar. The one manager who did not acquire its fund’s hybrid securities and broke a dollar was viewed as a special case.

August 2007 was the first time during which shareholders had reason to be concerned that defaults affecting some money market funds might spread to other funds. Although the list

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8 ICI Research Report, Pricing of U.S. Money Market Funds, Figure 14 (Jan. 2011).

of distressed SIVs was known and shareholders could confirm that managers were providing support for these investments, there was a concern that other SIVs could also default. There was also a general concern that structured financial products were not performing as has been anticipated, so there might be as yet undetected problems with other types of asset-backed securities.

Federated and other major money market fund managers engaged in extensive investor education and outreach to allay these concerns. On our part, we held regular conference calls with investors and intermediaries, spoke openly with the financial press and provided information to the Federal Reserve and the Commission. Because Federated performs an in-depth credit analysis of every security held in its funds, as required by Rule 2a-7, we could explain the intricate details of the asset-backed commercial paper held by our funds. We believe that our efforts, and the efforts of others, shored up shareholders' confidence in money market funds, to such as degree that they moved cash into the funds as market conditions became increasingly uncertain.

The events in September 2008 unfolded too rapidly for anyone to attempt education or outreach efforts, and it is unlikely that such efforts would have succeeded. The Lehman Brothers bankruptcy was preceded by the government takeover of Fannie Mae and Freddie Mac, and coincided with the government rescue of AIG and the acquisition of Merrill Lynch by Bank of America. At the time, there were serious questions regarding the viability of Citicorp, Goldman Sachs, Morgan Stanley and many other major U.S. financial institutions.[9] This uncertainty caused the credit markets to "freeze up," as few were willing to provide liquidity for any instruments other than U.S. government obligations.

Under these extreme conditions, it should not be surprising that some money market fund shareholders were concerned about further defaults in their fund's portfolio and the possibility that such defaults would eventually overwhelm the manager's capacity to support a stable price. In other words, many shareholders probably sought to redeem their shares before "something else happened." This is more plausible than supposing that shareholders redeemed from funds that did not hold any defaulted securities or that had been fully supported by their managers because of concerns over the funds' shadow prices (which, according to the ICI report, did not come close to breaking a dollar) or in anticipation of a "fire sale" by the funds.

If our analysis of September 2008 is correct, then there is no reason to believe that the Reserve Primary Fund breaking a dollar would have led to wide-scale redemptions by itself. The historical evidence strongly indicates that shareholders would have responded to the failure by determining what other funds were exposed to Lehman Brothers and whether their managers had provided support. Shareholders would not have reflexively redeemed from funds without any exposure or that had received manager support, so there would not have been large-scale redemptions from these funds. Put differently, the evidence indicates that the "run" in September 2008 was a consequence of systemic risks *already present* in the financial system, namely the

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9 *E.g.*, *The Banking Crisis Trickles Up*, New York Times C-1 (Sep. 30, 2008) ("The crisis gripping the nation's banks took a troubling turn … as investors' confidence in even the largest and strongest institutions spiraled lower. … Even shares in the three banks that have survived the crisis as the largest in the industry — Bank of America, JPMorgan Chase and Citigroup — fell more than 10 percent … as anxiety gripped markets. Goldman Sachs and Morgan Stanley, which transformed into bank holding companies last week, fell more than 12 percent.")

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belief that the same forces that caused Lehman Brothers to fail and required AIG and Merrill Lynch to be rescued also might lead to the failure of other major financial institutions. Money market funds were not, however, an independent source of systemic risk.

To be clear, Federated is not arguing that money market fund redemptions did not have a severe impact on the credit markets or that federal intervention was unwise. Instead, we are pointing out that the redemptions were a response to other systemic risks, similar to the curtailment of interbank lending during the same period. We have not heard anyone claim that interbank loans create systemic risk because banks stop lending during a financial crisis, so we do not understand why the Commission would accept the claim that money market fund shareholders pose a systemic risk when they redeem their shares during such a crisis.

Our analysis also has important implications for the reforms being considered by the Commission. If runs are a response to other systemic risks in the system, then floating the share price will not stop runs. Shareholders will want to get their money out before "something else happens," and these redemptions will eventually force funds to sell their securities into a distressed market. The Squam Lake Group's buffer also will not help the situation, because it is only available to cover losses, not to provide liquidity to the funds. Panicked investors who would have worried about the manager's capacity to support its funds will now worry about the manager's capacity to maintain the buffer, and will probably make the same decision to redeem their shares. The buffer will protect shareholders from some of the losses incurred on the resulting forced sales, but the buffer will not do anything to protect the credit market or to allow money market funds to continue funding governments, financial institutions and corporations.

This is why an emergency liquidity facility remains the only viable alternative for addressing potential runs by money market fund shareholders. By providing liquidity to funds, it would help prevent a "fire sale" and provide time for managers to reach out to shareholders to allay whatever fears are motivating their redemptions. The liquidity facility also avoids the true moral hazard of shareholders who invest in funds based on the manager's capacity to provide support rather than the integrity of the fund's portfolio.

IV. A RESERVE REQUIREMENT IS NOT A VIABLE SOLUTION

We now address the practical aspects of the Squam Lake Group's proposal that money market fund managers maintain reserves against potential defaults. Their comment letter provides the following description of their proposal:

> The manager of a stable-NAV money market fund must provide dedicated liquid financial resources that, in combination with those represented by the assets of the fund class investors, are sufficient to achieve a net buffer of "X" per dollar of net asset value. These additional resources are to be drawn upon as needed to support fund redemptions at one dollar per share until the fund converts to a floating-NAV or until the buffer resources are exhausted. That is, at the end of each business day, the combined resources available to fund investors represented by the sum of dedicated additional sources and the previous day's marked-to-market per-share value of the fund's assets must exceed 1+X per share held as of the end of the current day. The fund must convert to a floating-NAV fund within a regula-

tory transition period, such as 60 days, in the event that the fund manager falls out of compliance with this buffer requirement.

The first problem with this proposal is the proposed transition period from a stable to a floating NAV. This aspect of the proposal is at odds with the Squam Lake Group's analysis of why shareholders run from money market funds. If shareholders know that, on a future date, their shares may be priced below $1.00, then they will redeem before that date. Therefore, allowing any time to elapse between the failure to meet the buffer requirement and conversion to a floating share price should guarantee that shareholders will run from a fund immediately after its advisor fails to meet the buffer requirement. In other words, any failure to meet the buffer requirement will necessarily result in the liquidation of the affected fund and a related "fire sale" of the fund's portfolio.

The second problem is that the buffer requirement will increase the frequency of fund liquidations. The proposed buffer will not prevent any fund liquidations, because the manager must immediately restore any amounts taken from the buffer to cover losses. If a manager did not have enough capital to support a stable price after a default, then it would not have enough capital to restore the buffer and its funds would be liquidated. Thus, the buffer would not prevent funds from liquidating as a consequence of external events.

The buffer also would result, however, in the liquidation of funds that did not hold any defaulted or distressed securities if their managers cannot raise capital rapidly enough to increase the buffer in response to growth in the fund's assets. As a result, while the buffer would not reduce any existing risk of a fund liquidating due to a default, it would add an arbitrary risk of liquidation for failure to maintain the buffer. All the buffer would accomplish is to reduce the potential losses to shareholders upon a fund's liquidation.

Third, the buffer would be far too costly to managers and would probably drive them out of the business of managing money market funds. The Squam Lake Group is not specific on the amount of buffer that manager would be required to maintain. Their comments use a 3% buffer for purposes of illustration, but note that a 1.69% buffer would have been sufficient to cover the Lehman Brothers commercial paper held by the Reserve Primary Fund. The Moody's study of the manager support found a mode at support levels between 0% and 2% of the fund's total assets. We will therefore use a 2% buffer for purposes of analysis.

According to ICI data, in 2010, the asset-weighted average management fee charged to money market funds (after waivers and fund expense reimbursements) was 11 basis points. This means that a 2% buffer would represent over 18 years of the average money market fund manager's *gross* revenues. In other words, it would take nearly two decades before a manager received back from the fund the money it set aside for the buffer, before taking the manager's expenses into account.

While it is true that, due to continued low short-term interest rates, fees are at historical lows, the result would not change much even under ideal market conditions. In 2006-2007, before the Federal Reserve started cutting interest rates, the asset-weighted average management fee was 15 basis points, so a 2% buffer would still represent over 13 years of gross revenues.

Of course, no manager could actually afford to fund its buffer by setting aside all of its revenues for 13 to 18 years. To establish a 2% buffer at current asset levels, managers would have to raise $55 billion in capital. The cost of such capital would turn money market fund management into an inherently unprofitable business. For example, paying a 5% return on the capital required for a 2% buffer would equal 10 basis points of a manager's total money market fund assets under management. This is nearly the entire average management fee currently being charged to money market funds, and two-thirds of the average fees charged during more normal market conditions. A money market fund manager cannot continue to make a profit after such a tremendous increase in its capital costs.

Finally, managers could not pass through the costs of any buffer requirement to their funds' shareholders. The Investment Company Act prohibits a manager from raising its fees without shareholder approval. There is no reason to suppose that shareholders would approve any increase in fees to fund a buffer requirement. In fact, it is unlikely that enough shareholders would respond to a proxy solicitation to establish the quorum necessary to have such a vote. Money market fund shareholders generally vote with their feet, by moving their money from one fund to another, rather than via the proxy process. The fact that the shareholders can redeem without realizing any gains or losses facilitates this behavior. Thus, any meaningful buffer requirement will simply put managers out of the business of managing money market funds.

V. CONCLUSION

As we have shown, the recommendations made in these comments letters are based on a superficial analysis of money market funds and their shareholders. They criticize the fact that funds are not supervised in the same manner as banks, without recognizing the historical effectiveness of the Commission's and directors' supervision of the funds. They raise the specter of moral hazard without considering the actual terms of the Temporary Guarantee Program. They speculate on shareholders motivations for redeeming from the funds in September 2008 without regard for numerous events during the preceding three decades that did not lead to widespread redemptions. Finally, the Squam Lake Group failed to consider the necessary consequences of its proposed buffer (more frequent and arbitrary fund liquidations) or estimate the enormous cost of a buffer relative to the fees earned for managing money market funds.

Once these points are analyzed in greater depth, it becomes clear that the commenters have not provided a convincing case for their proposed reforms. We continue to believe that the Commission would be better advised to focus on the reforms supported by an overwhelming majority of the comment letters—namely the creation of an emergency liquidity facility.

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

Yours very truly,

/s/ John W. McGonigle
Vice Chairman