Federated Investors, Inc.
Federated Investors Tower
1001 Liberty Avenue
Pittsburgh, PA 15222-3779
412-288-1900 Phone
FederatedInvestors.com

Federated.

May 17, 2013

The Honorable Mary Jo White, Chair
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Re: Briefing Book on Money Market Fund Reform:
Assessment of the Impact of Proposed Structural Reforms to
Money Market Funds Based on a Review of Their Operations,
History and Regulation

Dear Chair White:

First, let me congratulate you on your recent appointment as Chair of the Securities and Exchange Commission ("SEC"). Your record in both public service and private practice and your reputation of professionalism augurs well for your ability to meet the challenges ahead in this important role. Your appointment comes at a critical juncture as our markets continue to emerge from the Financial Crisis of 2008.

While the SEC has a daunting list of priorities, including adoption of rules mandated by the Dodd Frank Act, one of the most pressing questions facing the SEC is whether there should be additional reform measures imposed on money market funds. In view of this we have enclosed for your review a Briefing Book prepared at our direction to assist you in the important task of determining the appropriate course of money market fund reform. While this piece will likely be treated by the SEC as a comment letter for purposes of the public record, it is intended as a primer on the subject of money market funds and the history of their operations and regulation.[1] The Briefing Book was prepared by Stephen Keen, one of the nation's leading experts on money market fund regulation. To provide context to such a weighty consideration the Briefing Book uses a real prime money market fund advised by Federated to explain how money market funds operate and why shareholders use them. The fund's performance over the past twenty years is reviewed, with particular attention to the effects of the Financial Crisis. The book also discusses, among other things, the fact that the animus shown recently by the Federal Reserve Board toward money market funds is not a new phenomenon, but in fact attempted to limit their appeal to investors soon after their creation.

[1] As one of the nation's largest and most experienced managers of money market funds, Federated Investors, Inc. ("Federated") has spent nearly 40 years working with these funds and their shareholders as markets and regulation have evolved. Federated, through its subsidiaries and affiliates, currently manages over $250 billion in money market assets.

Federated.

The Briefing Book attempts to synthesize into a single document the history of money market fund regulation from inception in the 1970's through the recent efforts of the Financial Stability Oversight Council (FSOC) to use its Section 120 authority under Dodd Frank to suggest additional reforms to the Securities and Exchange Commission ("SEC") as the primary regulator of money market funds.[2] Finally, it demonstrates that the reforms suggested by FSOC not only do not address the policy concerns they've articulated, but also would almost certainly cause the demise of what has probably been the single most successful product innovation achieved by SEC regulation.[3] This success is both an undeniable and demonstrable fact when measured by investor preference (over 2 ½ trillion in assets) and the benefits conferred on 56 million investors over time in terms of nearly one half trillion dollars in returns over and above what investors might have earned in deposit accounts at banks.[4]

In light of your recent appointment as Chair and the importance of the task before you to investors and the capital markets, it is our hope that this Briefing Book helps clarify the critical issues that are involved in an undertaking of further reform of money market funds. Please let me know if you have any questions. In any event we would like to meet with you to discuss this matter further. We look forward to working with you on enhancing the resiliency of money market funds.

Sincerely,

J. Christopher Donahue
President & CEO

---

[2] A process which has been publically questioned in respect of money market funds as outside the scope of the Council's legislative mandate. *see, e.g.*, Comment Letter of Arnold & Porter on behalf of Federated Investors (Dec. 15, 2011) on FSOC Proposed Rule: Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies, http://www.regulations.gov/#!documentDetail;D=FSOC-2011-0001-0053; Comment Letter of Arnold & Porter on behalf of Federated Investors (June 10, 2011) on Federal Reserve, FDIC Proposed Rulemaking on Resolution Plans and Credit Reports Required, avail. at http://www.federalreserve.gov/SECRS/2011/July/20110701/R-1414/R-1414_061011_81449_500089184441_1.pdf; Comment Letter of Arnold & Porter on behalf of Federated Investors (Mar. 30, 2011) on Federal Reserve Proposed Rulemaking Regarding Definitions of ''Predominantly Engaged in Financial Activities'' and ''Significant'' Nonbank Financial Company and Bank Holding Company; 12 C.F.R. Part 225, Regulation Y; Docket No. R–1405; RIN 7100–AD64, avail. at http://www.federalreserve.gov/SECRS/2011/April/20110401/R-1405/R-1405_033011_69273_589557907011_1.pdf. *See also* comment letters cited in footnote 3 below.

[3] See, Comment Letter of Arnold & Porter on behalf of Federated Investors (Dec. 17, 2012) on FSOC Proposed Recommendations Regarding Money Market Mutual Fund Reform (Docket Number FSOC-2012-0003)., avail. at http://www.regulations.gov/#!documentDetail;D=FSOC-2012-0003-0016; Comment Letters of Arnold & Porter on behalf of Federated Investors (Jan 25, 2013) (three separate letters with same date covering the three FSOC proposals), avail. at http://www.regulations.gov/#!documentDetail;D=FSOC-2012-0003-0072; http://www.regulations.gov/#!documentDetail;D=FSOC-2012-0003-0073; http://www.regulations.gov/#!documentDetail;D=FSOC-2012-0003-0074; Comment Letter of Arnold & Porter on behalf of Federated Investors (Feb. 15, 2013), avail. at http://www.regulations.gov/#!documentDetail;D=FSOC-2012-0003-0116.

[4] See, page 13 of the enclosed Briefing Book.

Federated.

cc: Commissioner Luis A. Aguilar
Commissioner Daniel M. Gallagher
Commissioner Troy A. Paredes
Commissioner Elisse B. Walter

Thoreau Bartman - Branch Chief, Office of Regulatory Policy
Diane Blizzard - Associate Director, Regulatory Policy & Investment Adviser Regulation
Norm Champ - Director, Division of Investment Management
Craig Lewis - Director & Chief Economist, Risk, Strategy, and Financial Innovation
Sarah ten Siethoff – Attorney/Adviser

ASSESSMENT OF THE IMPACT OF PROPOSED STRUCTURAL REFORMS TO MONEY MARKET FUNDS BASED ON A REVIEW OF THEIR OPERATIONS, HISTORY AND REGULATION

Federated Investors, Inc.
2013

Table of Contents

Endnotes appear at the end of each section.

Executive Summary

One of the first matters that the new Chair of the Securities and Exchange Commission (the "Commission") has confronted is the ongoing debate over money market fund reform. Former Chair Walter, other commissioners and the Director of the Division of Investment Management (the "IM Division") have identified this as a top priority of the Commission.[1] The Financial Stability Oversight Council (the "Council") has included money market fund reform at the top of its recommendations in each Annual Report,[2] and has proposed to exercise its powers under Section 120 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "DFA")[3] to recommend heightened standards for money market funds ("MMFs") to the Commission (the "FSOC Proposals").[4] The comment period for the proposed recommendations ended February 15, 2013. The Council has indicated that it may not make any recommendations, however, if "the SEC moves forward with meaningful structural reforms of MMFs before the Council completes its Section 120 process."[5]

In order to move forward with *structural* reforms, it is first critical to understand the structure of MMFs as they currently operate and whether proposed reforms are compatible with their continued operation. It is also necessary to understand how MMFs differ from other open-end management investment companies, known as mutual funds, and how those differences evolved. It is also important to understand how MMFs respond to market disruptions, particularly the extreme conditions of the recent financial crisis. Finally, a commissioner should appreciate the thoughtful and extensive regulations to which MMFs are currently subject.

Federated Investors, Inc. ("Federated")[*] commissioned this briefing book to help provide both the facts and the conceptual foundations needed to appraise proposed structural reforms of MMFs. The book begins (in Section 1) by explaining how nearly all MMFs have managed to preserve the value of their shareholders' investments, year-in and year-out, without any financial support from their sponsors or from the government. Using Federated's largest prime MMF as an example, this section explains:

- How the fund has provided for the past 23 years, without interruption or the intervention of its sponsor, daily liquidity to shareholders who purchase and redeem a billion shares a month.

[*] Federated has thirty-nine years of experience in the business of managing MMFs and, during that period, has participated actively in the money market as it has developed. The registration statement for Federated's Money Market Management fund first became effective on January 16, 1974, making it perhaps the longest continuously operating MMF to use the amortized cost method to maintain a stable net asset value.

- How the fund maintains a stable $1 net asset value per share (a stable "NAV") that is fair to its shareholders, who have earned billions more than they could have from other cash investment alternatives.
- Why shareholders rely on MMFs to meet their transactional, operational and strategic cash needs, and the enhanced levels of professional management, service and diversification these funds provide.
- The significant legal, tax, accounting and operational difficulties that changes in a share's price would create for these shareholders, if they were required to transact at a fluctuating NAV.

Section 2 uses the structural foundation established in Section 1 to explain why MMFs could not continue to operate under any of the FSOC Proposals for the following reasons.

- The proposal to force MMFs to float their NAVs would result in frequent fluctuations of trivial magnitude. Without any solutions for the tax and accounting problems these fluctuations would engender, the proposal would drive shareholders from MMFs to banks or other cash management alternatives. In addition, no one has found ways to address the legal and operational impediments to using a floating NAV fund for cash management.
- The proposal to require shareholders to maintain a minimum balance in their accounts, which would be "at risk" of subordination, is impossibly complicated and expensive. The proposal would drive intermediaries as well as shareholders from MMFs to banks or other cash management alternatives.
- Funds, their shareholders and their sponsors could not possibly afford the proposed capital requirements. In this extended period of near zero short-term interest rates, even a 1% capital requirement would represent several years of earnings for a MMF and a decade of fees for the fund's sponsor.

The Chair recently stated that, "As the SEC works to develop and propose meaningful money market fund reform, our goal is to preserve the economic benefits of the product …."[6] Section 2 shows why the FSOC Proposals conflict with the Commission's goal. Moreover, since the Council concedes that none of its proposals would remove the potential for MMF shareholders to run during a financial crisis, the FSOC Proposals also fail to address "potential redemption pressures and the susceptibility of these funds to runs."[7]

Section 3 provides a history of money market fund regulation, including:

- The history of the Commission's interpretations and hearings which led to the exemption of MMFs from certain pricing standards of the Investment Company Act of 1940 (the "ICA");

- The Federal Reserve's initial efforts to limit the appeal of MMFs to cash investors; and

- The Commission's adoption and extensive amendment of Rule 2a-7.

Section 4 reviews the impact of the recent financial crisis on MMFs. This section draws almost exclusively on the findings of the Financial Crisis Inquiry Commission and a report prepared by the Commission's Division of Risk, Strategy and Financial Innovation (the "Risk Fin Division") to show:

- MMFs did not contribute to the "bubble" in real estate financing that was the primary cause of the financial crisis;

- Prime MMFs absorbed, without any government assistance, the initial shocks from the collapse of the bubble in 2007;

- Prime MMFs were not otherwise affected by the financial crisis until its climax during the days following Lehman Brothers' bankruptcy, which touched off an "extraordinary rush" to safety that spread to every corner of the global credit markets; and

- Cash began to flow back into prime MMFs within three weeks after Lehman Brothers' bankruptcy and continued to do so during the remainder of the financial crisis.

Section 5 provides a summary of how money market fund regulations, enhanced by amendments adopted by the Commission in 2010, protect shareholders through full disclosure, comprehensive investment limitations and enhanced oversight by the fund's board of directors or trustees (the "Board"). The briefing book concludes with an assessment of the following six questions, the answers to the first four of which are "no," posed in one of Federated's comment letters on the FSOC Proposal.

(a) Would any of the FSOC Proposals have prevented the flight to safety that occurred from virtually all asset classes in September 2008?

(b) Would any of the FSOC Proposals have prevented the freeze-up in the short-term credit markets that took place during the depths of the financial crisis?

(c) If money market funds had not existed in 2008, is there any reason to believe the seizing up of the commercial paper market and short-term credit markets more broadly would not have occurred?

(d) Would any of the FSOC Proposals prevent a "run" from money market funds or the short-term credit markets in a future financial crisis?

(e) If, as a result of regulatory restrictions, money market funds do not exist going forward, or if their assets under management are substantially reduced, where will those assets move, and will there be a consequent reduction or increase in systemic risk in the financial markets?

(f) What steps are most critical for the Council to take to prepare for the possibility of a future financial crisis?

Once you have reviewed these materials, Federated is confident you will agree that, if the goal of further MMF reform is to address lingering concern about the potential for shareholders to run, then only targeted reforms (such as Federated's proposal for temporary "gates") designed to address that specific concern should be considered, which would further the Commission's paramount mission of protecting investors and promoting efficiency, competition, and capital formation.[8]

---

[1] *See, e.g.*, Dave Michaels, *SEC's Walter Calls Designated Successor White a Quick Study*, BLOOMBERG (Feb. 1, 2013), http://www.bloomberg.com/news/2013-02-01/sec-s-walter-praises-nominee-white-as-she-leads-agency-for-now.html, and Began Wilcox Volz, *SEC Outlines Three Main Regulatory Priorities*, IGNITES (Mar. 19, 2013), http://www.ignites.com/c/490661/54771?highlight=champ. ("Money market fund reforms, valuation guidance and rules on identity theft red flags are the SEC's top short-term regulatory goals, according to Norm Champ, head of the agency's Division of Investment Management.").

[2] Financial Stability Oversight Council, 2013 ANNUAL REPORT at 11 (approved Apr. 18, 2012), http://www.treasury.gov/initiatives/fsoc/Documents/FSOC%202013%20Annual%20Report.pdf.

[3] 15 U.S.C. § 5330.

[4] Proposed Recommendations Regarding Money Market Mutual Fund Reform, Docket Number FSOC–2012–0003, 77 Fed. Reg. 69455 (proposed Nov. 13, 2012).

[5] 2013 ANNUAL REPORT, *supra* note 2, at 12.

[6] Chair Mary Jo White, U.S. Securities and Exchange Commission, *Regulation in a Global Financial System*, speech to the Investment Company Institute General Membership Meeting (May 1, 2013), http://www.sec.gov/news/speech/2013/spch050313mjw.htm.

[7] *Id.*

[8] Section 2(c) of the ICA, 15 U.S.C. § 80a-2(c), provides "Whenever pursuant to this title the Commission is engaged in rulemaking and is required to consider or determine whether an action is consistent with the public interest, the Commission shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation."

1. Operation and Management of Money Market Funds

Although some advocates of money market fund reform try to do so, it is not possible to discuss proposed reforms without first understanding how MMFs work and why shareholders use them. This section provides this basic understanding by examining the history and operations of the Federated Prime Obligations Funds ("POF"), the largest prime "institutional" MMF managed by Federated Investment Management Company ("FIMCO"), a Federated subsidiary registered with the Commission as an investment adviser. Given that prime "institutional" funds experienced the heaviest redemptions during the peak of the financial crisis in 2008, we thought it appropriate to focus on a fund of this type. We must emphasize that POF is a typical prime MMF; you can find similar funds at Fidelity, JPMorgan Chase, Vanguard, Blackrock or other MMF managers.

1.1 Background Information

POF began offering its shares in 1990. For over twenty-three years, POF has sold and redeemed its shares at a stable value of $1 per share. It has never suspended the right to redeem its shares, delayed the payment of redemptions or received a penny of capital support from FIMCO.[1] As of December 31, 2012, POF had total net assets of $ 48.457 billion,[2] making it the seventh largest prime MMF.[3] Chart 1 on the next page shows the growth in POF's assets from 1992 through 2012.[*]

POF is a series[4] of Money Market Obligations Trust ("MMOT"), a business trust formed under Massachusetts law. A Board consisting of six independent trustees and two trustees who are directors, officers and controlling shareholders of Federated oversees POF and the other series of MMOT. POF is rated AAAm, Aaa-mf and AAAmmf by Standard & Poor's, Moody's Investors Services and FitchRatings, respectively.

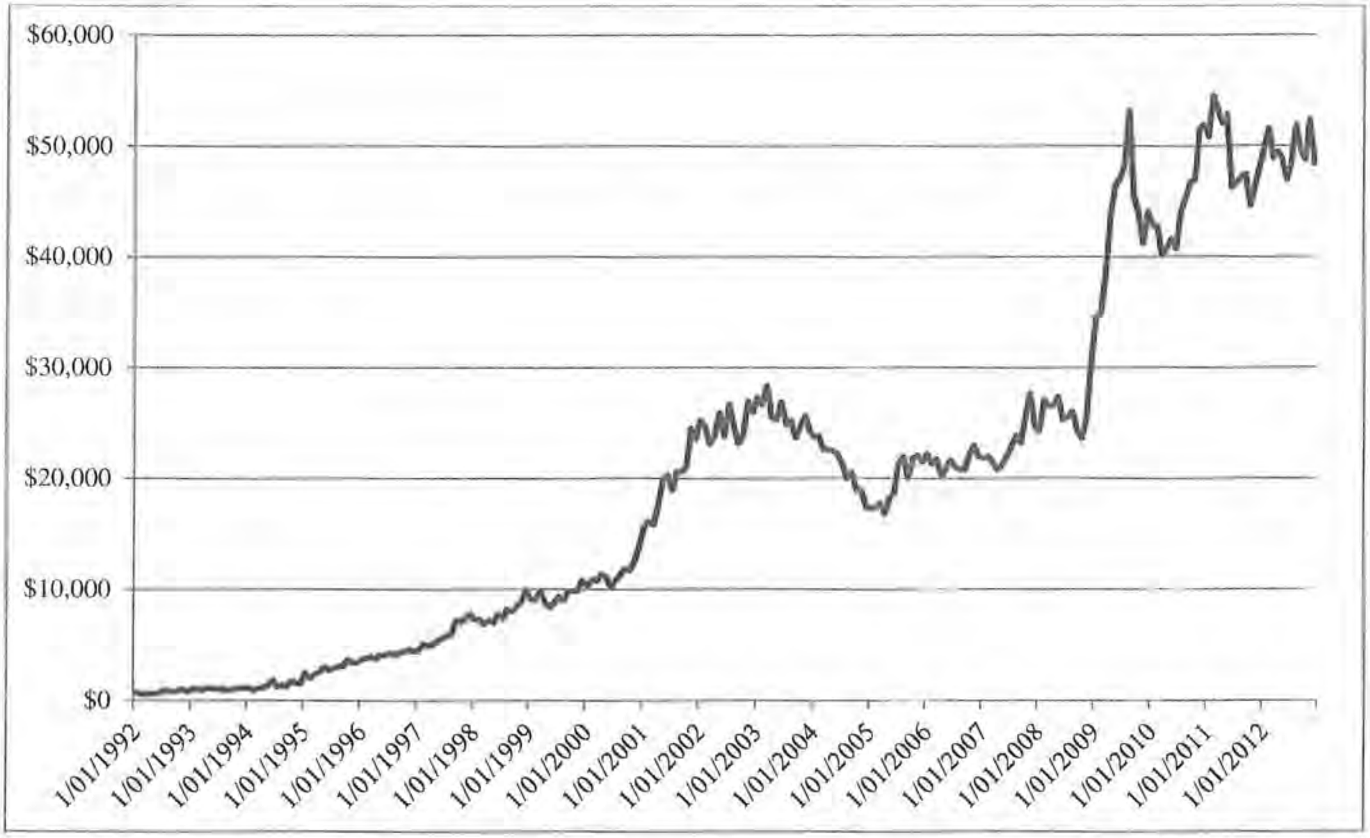
POF is a "prime" MMF insofar as most of its portfolio normally consists of bank and corporate obligations. POF can invest, however, in any type of obligations permitted by regulatory or rating requirements, including U.S. Treasury securities, securities issued or guaranteed by other federal agencies and state and municipal obligations.[†]

---

[*] Although POF began in 1990, we could only obtain shadow price information starting in August 1991. For ease of analysis, we limited all of the enclosed charts to the period from January 1, 1992 to December 31, 2012.

[†] Securities issued or guaranteed by the U.S. Treasury or by a federal agency or instrumentality (such as Fannie Mae or a federal home loan bank) are "Government Securities" as defined in ICA § 2(a)(16), 15 U.S.C. § 80a–2(a)(16). Money market funds that invest 80% or more of their assets in Government Securities are referred to as "Government

Chart 1
Prime Obligations Fund Monthly Net Assets (1992-2012)
(amounts in millions)



FIMCO's Chief Investment Officer for Global Money Markets, a senior portfolio manager and their team manage POF's investments. The Chief Investment Officer has over 27 years, and the senior portfolio manager has over 22 years, of investment experience. FIMCO has a staff of 12 credit analysts who review and monitor money market investments (including federal, state and local government securities), and a staff of 13 traders who execute portfolio transactions on behalf of all of Federated's MMFs.

FIMCO's credit staff controls the list of issuers in which POF is permitted to invest. Each credit analyst is responsible for the issuers in her or

---

Funds," and those that invest 80% or more of their assets in U.S. Treasury obligations are referred to as "Treasury Funds."

Although state and municipal obligations typically pay interest that is exempt from federal (and some state) income taxes, such tax-exempt income does not make up a sufficient portion of POF's annual income to permit it to pay tax-exempt dividends to its shareholders. "Tax Exempt Funds," as defined in 17 C.F.R. § 270.2a-7(a)(26), pay dividends exempt from regular federal income tax; "Single State Funds," as defined in 17 C.F.R. § 270.2a-7(a)(25), pay dividends that are also exempt from taxes in a designated state.

his assigned sectors. In order to be approved for investment, an issuer must receive the recommendation of the assigned analyst, and a credit committee comprised of portfolio managers and other analysts must approve the recommendation. FIMCO's Director of Money Market and Municipal Fixed Income Research, who has over 32 years of experience analyzing money market credit and instruments, chairs the credit committee. The credit analyst and credit committee also determine which Federated MMFs are permitted to invest in an issuer, as well as the maximum term of investments and the maximum percentage of the portfolio that may be invested in the issuer. Traders may acquire on POF's behalf only instruments issued or guaranteed by organizations approved by the credit committee.

The credit analysts spend most of their time monitoring their approved issuers. An analyst may place a "hold" on an issuer, preventing funds from making further investments in the issuer, any time the analyst needs to investigate a development that may adversely affect the issuer's creditworthiness. The analyst may also remove an issuer from a fund's approved issuer list, shorten the maximum term of new investments or curtail the percentage of the portfolio that may be invested in an issuer. Although credit committee approval is required for an issuer to be placed on the list of approved investments, a credit analyst may limit further investments in an issuer on his or her own initiative, which makes it easier to avoid credit risk than to take it.

POF is classified as an "institutional" MMF because it requires a minimum initial investment of $500,000. POF does not restrict the type of person who may open an account. Thus, POF shareholders may include individuals as well as the full gamut of institutions, such as corporate and personal trustees, corporations, municipalities, government-sponsored enterprises, futures clearing organizations, special purpose entities and pension plans. There are no small investors, however, who could be affected by the redemption activities of POF's shareholders.

POF is open each day the New York Stock Exchange is open for trading. POF accepts purchase and redemption orders until 5 p.m. Eastern Time, and pays redemption orders on the day they are received.* This gives shareholders on the West Coast access to their cash until 2 p.m. Pacific Time, as well as giving shareholders on the East Coast access to their cash until the end of each business day. A shareholder may request any number of transactions during the day.

* POF could not operate until 5 p.m. without using the amortized cost method of valuing its shares, discussed *infra* in Subsection 1.2. Because the Fedwire closes at 6 p.m., there is not enough time to estimate the underlying market value of the portfolio as of 5 p.m., process redemption orders for a billion or more shares and still send redemption wires on a same-day basis.

POF handles an enormous volume of transactions each day. During its last fiscal year, POF sold over 292 billion shares and redeemed over 290 billion shares. This is six times the number of shares outstanding at the beginning and at the end of the fiscal year. In other words, the volume of POF's share transactions was the equivalent of every shareholder fully redeeming their account in one month and then putting all of the cash back in the next month. As 78% of POF's shares were held in omnibus accounts, which hold shares for multiple investors and net their underlying daily transactions before executing a single transaction order for the omnibus account, the volume of transactions by the ultimate shareholders was actually much higher.

Of course, POF shareholders rarely engage in such wholesale redemptions of their account balance. The volume of transactions is primarily a product of a regular series of transactions by each shareholder, as the shareholder receives cash for investment and uses cash to pay its obligations. Federated has a staff that monitors these transactions for large cash inflows or outflows or recurring investment patterns associated with an account. All new accounts are reviewed to determine what type of shareholder will be using POF. Trading activity is monitored at 15-minute intervals and portfolio managers are alerted to any significant transactions (e.g., a purchase or redemption that exceeds 0.5% of the outstanding shares). Portfolio managers may request further investigation of an account, in which case a client liaison or sales representative will contact the account holder to ask about anticipated cash flows. The portfolio managers use this information to determine the anticipated range of redemptions and to maintain a corresponding level of liquidity in the portfolio.

1.2 How POF Maintains a Stable Net Asset Value

POF uses the amortized cost of its portfolio securities to calculate its NAV, which is the price at which it sells and redeems its shares. Amortized cost accounts for the difference between the cost of a security (its purchase price) and the amount payable at maturity (its face amount). Under the amortized cost method, an investment is valued initially at its purchase price. The fund then adjusts over the term of the investment the amount of interest income accrued each day to account for any difference between the purchase price and the face amount. If the face amount exceeds the purchase price (a discount), then the daily income accrual is increased; if the purchase price exceeds the face amount (a premium), then the daily income accrual is decreased. The fund adds the amount of the increase to (in the case of a discount), or subtracts the amount of the decrease from (in the case of a premium), the investment's cost each day, so that, when the instrument matures, its adjusted cost will equal its face amount.[5] The fund uses this adjusted cost to value the investment each day.

The following example illustrates these concepts. Suppose a fund holds a $10 million certificate of deposit ("CD") that matures in 30 days and will pay $9,000 in interest at maturity (an annual interest rate of roughly 1.1%). If the fund acquired the CD for its face amount of $10 million, it would accrue interest at a rate of $300 per day and never adjust the cost of the CD. If, however, the fund paid a $1500 premium for the CD (i.e., the purchase price was $10,001,500), the fund would amortize the premium by (a) reducing the interest accrual by $50 a day to $250 and (b) reducing the cost of the CD by $50 dollars a day until it equaled $10 million at maturity. This reflects the fact that $1500 of the interest paid at maturity represents a return of the premium rather than income. On the other hand, if the fund bought the CD at a $1500 discount (i.e., the purchase price was $9,998,500), the fund would accrete the discount by (a) increasing the interest accrual by $50 a day to $350 and (b) increasing the cost of the CD by $50 dollars a day until it equaled $10 million at maturity. This reflects the fact that $1500 of the face amount represents income rather than a return of the purchase price.

Because accrual of income increases the assets of an investment company, a MMF needs an offsetting increase in liabilities to maintain a stable *net* asset value. Dividends, once declared, represent liabilities that the company owes to its shareholders. POF therefore declares a dividend each business day equal to its daily net accrued income, thereby preventing a buildup in undistributed income that could affect its stable NAV.[6]

As discussed in Subsection 5.8 below, regulations permit a MMF to use amortized cost to maintain a stable NAV "only so long as the board of directors believes that it fairly reflects the market-based net asset value per share." POF must estimate its market-based net asset value per share (referred to as its "shadow price") each week and the Board monitors the deviation between the shadow price and $1 at each regular meeting. Chart 2 on the following page shows how POF's historical shadow price has fairly reflected its stable $1 NAV.[*] During this period, the shadow price deviated from $1 by an average of only 3 basis points.

Prior to the financial crisis, only once did the shadow price deviate under $1 by more than 10 basis points. This was in early May 1994, after a series of significant rate hikes by the Federal Reserve Board. The deviation was back under 10 basis points the following week.

POF's lowest recorded shadow price occurred during the height of the financial crisis, at the beginning of October 2008. Even during the most severe market conditions experienced since the Great Depression, the devia-

[*] Prior to 1999, the Board received only biweekly shadow prices for POF. For consistency of presentation, for the period from 1992 through 1998, Chart 2 includes interpolated shadow prices for the weeks a shadow price was not recorded.

tion in POF's shadow price was only half of the amount required to "break a dollar." The deviation exceeded 10 basis points for a period of only five weeks.

Chart 2
Historical Shadow Prices (1992-2012)

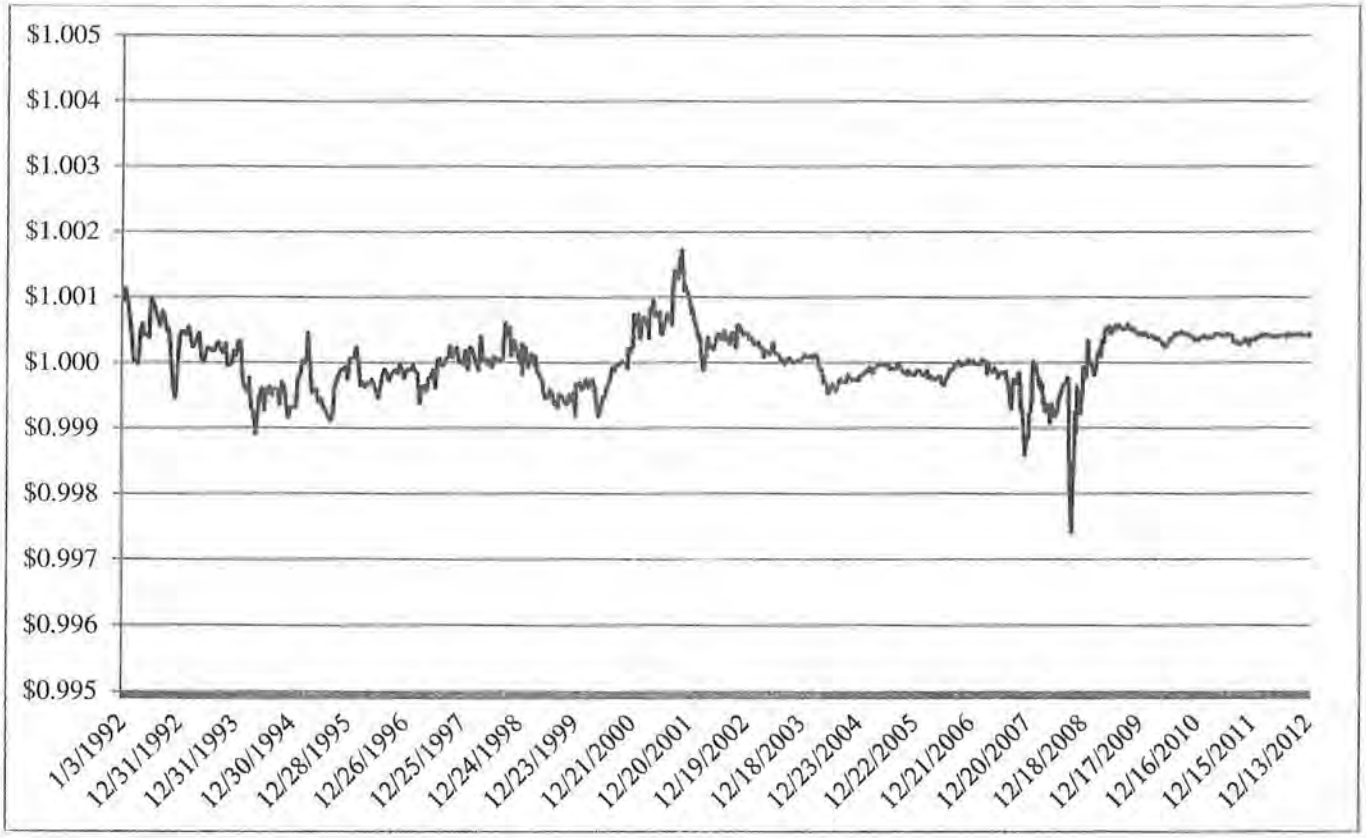
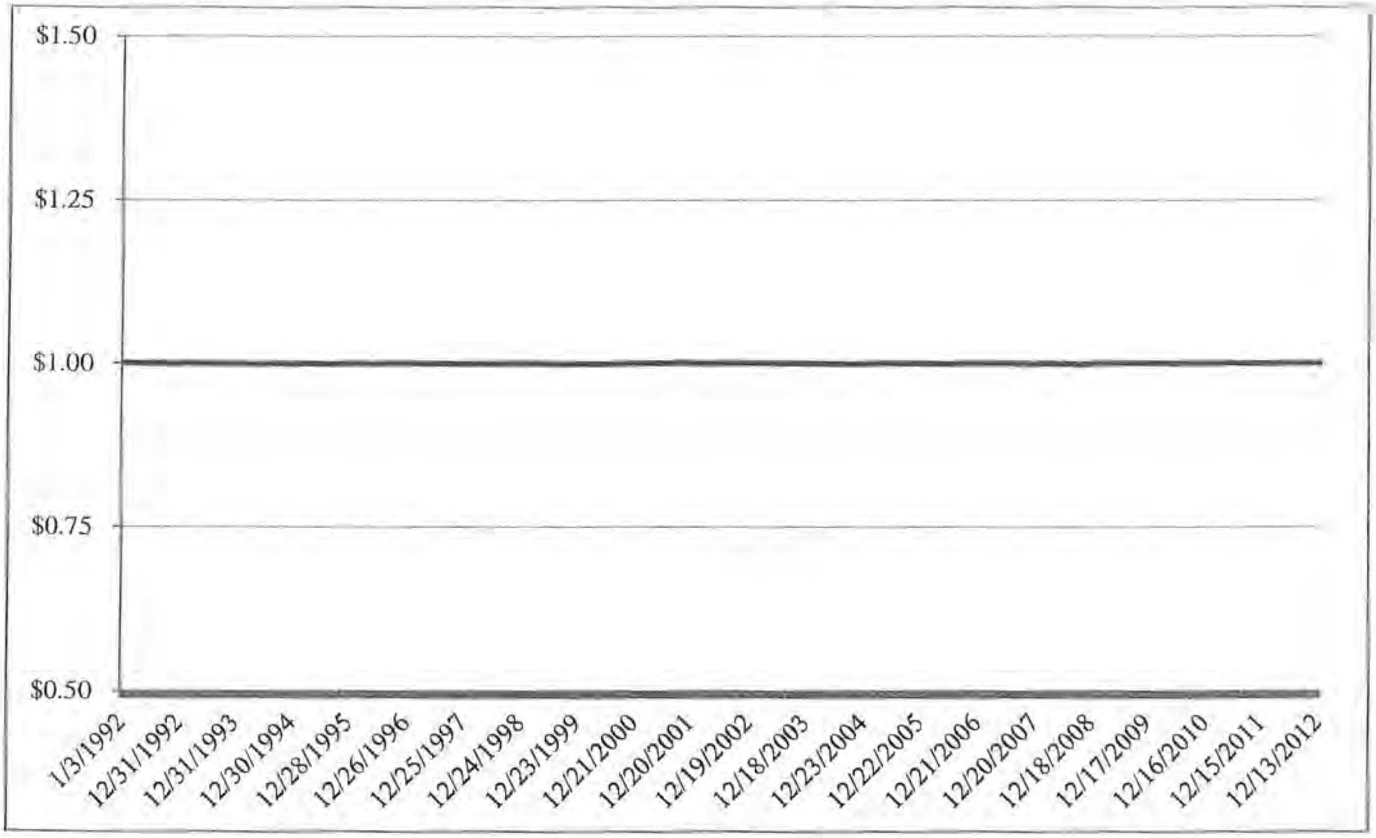


Chart 2 covers an extraordinarily small scale (the vertical axis has a range of only one cent) for a very long period (the horizontal axis spans two decades). As discussed in Subsection 5.8 below, $1.005 to $0.995 is the range in which a fund's shadow price must normally remain for the fund to use the amortized cost method of maintaining a stable $1 NAV. This scale has the effect of magnifying changes in the shadow price one-hundred times. If, in contrast, one looks at the shadow price over a range of $1, as shown in Chart 2A, its fluctuations are barely discernible. Chart 2A depicts the inherent stability of POF's shadow price.

Chart 2A
Historical Shadow Prices (1992-2012)



1.3 Why Investors Use POF

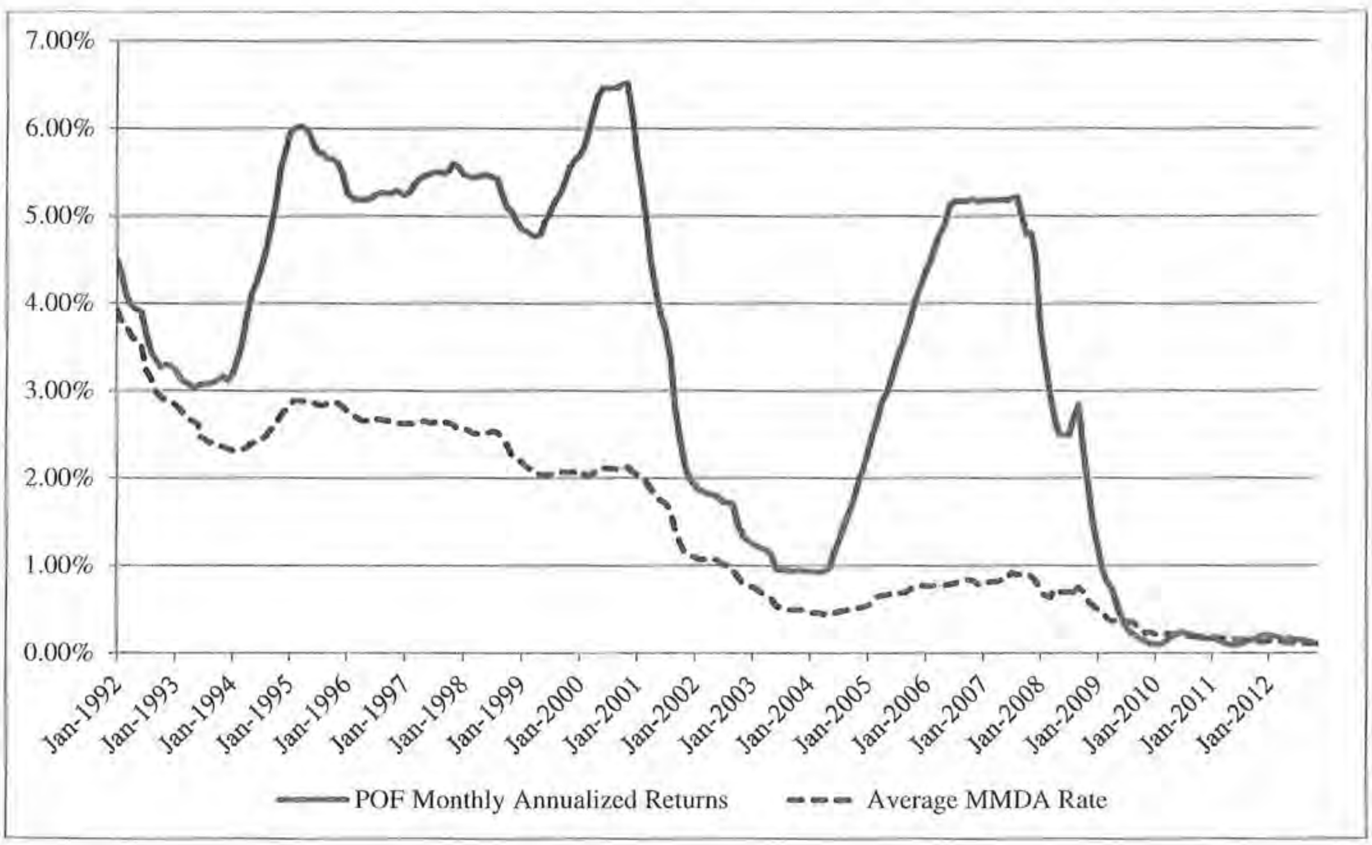
Investors use MMFs for liquidity. Their liquidity needs include: "(i) transactional cash required for daily liquidity needs (often part of daily 'sweep' arrangements); (ii) operational cash that is not part of a daily 'sweep' but is needed for short-term liquidity (e.g., weekly payroll funding); and (iii) strategic cash that is part of an asset allocation strategy with a longer term perspective."[7] There are many types of products designed to meet these liquidity needs, including bank accounts and common and collective trust funds administered by banks. Large institutional investors may also use unregistered investment funds, overnight repurchase agreements and commercial paper programs. Many investors prefer to use MMFs such as POF for their liquidity needs, however, because of their unique features and benefits.

First, POF provides its shareholders with professional management. Few institutional investors can afford to hire credit analysts to review their cash investments. Even fewer firms would have analysts with the training and experience of the analysts who work at FIMCO. Institutional investors generally would not receive the same coverage from dealers as FIMCO does, and could not participate in many of the investment opportunities available to POF. By spreading the cost among thousands of shareholders, POF provides its shareholders with higher quality management services than they could afford to retain on their own.

Second, POF provides its shareholders with the benefit of diversification. POF regularly invests in scores of different companies, which limits the potential impact of a default to its shareholders. Even institutional investors generally do not have the resources to spread their cash so widely among different issuers. Moreover, it is not practical to juggle deposits and payments among multiple accounts or investments. Shareholders cannot replicate on their own anything close to the diversification provided by POF.

Third, historically, investors earn a higher return by investing their cash in POF then they would earn from a bank account or overnight investments. Chart 3 shows the annualized monthly return on POF's Institutional class of shares and the average rate paid by banks on money market demand accounts ("MMDAs").

Chart 3
Prime Obligations Fund's Monthly Return vs. Average MMDA Rate (1992-2012)[8]



From 1992 through 2009, POF consistently provided a higher return than an MMDA. The higher returns reflect a fundamental difference between banks and MMFs. Whereas banks offer depositors rates that will maximize the banks' profits from lending deposits, MMFs must pay their full earnings (after deduction of a disclosed expense ratio) to their shareholders. This assures that MMF shareholders will receive returns that approximate the money market rates earned by the largest and most sophisticated financial institutions. The extraordinarily low short-term interest rates established by the Federal Reserve in response to the financial crisis have produced a temporary convergence of POF's returns and the average rate paid on MMDAs since 2009.

By multiplying the assets shown in Chart 1 by the difference in yields shown in Chart 3, we find that POF increased investor returns by $5.2 billion over what the same assets would have earned in the average MMDA during the period. The aggregate economic benefit of MMFs to the public is even more impressive. Using data from the Investment Company Institute (the "ICI"), iMoneyNet and the Bank Rate Monitor, Federated estimates that, during the period from 1985 through 2008, taxable MMFs increased investor returns by over $450 billion as compared to what the same assets would have earned in MMDAs.

Prior to 2010, federal law prohibited banks from paying interest on corporate demand deposits and prohibited corporations, partnerships, and other for-profit businesses from owning interest-bearing NOW transaction accounts. Without a MMF like POF, these shareholders would not have earned anything on their cash unless their bank offered to sweep their balances into overnight investments or they could afford to trade directly in the money markets. It is impossible to determine the extent to which POF's shareholders could have used alternatives to non-interest bearing deposit accounts or to quantify the returns they might have realized through these alternatives. Their additional returns might therefore be higher or lower than $5.2 billion. Nevertheless, we can be reasonably certain that additional returns earned by POF's shareholders are measured in billions of dollars.

1.4 Why Investors Need a Stable NAV

The need for a stable value derives from investors' liquidity needs. For example, the point of strategic cash in an asset allocation strategy is to isolate part of the investor's portfolio from fluctuations in the stock and bond markets. This gives the investor latitude to take losses and gains on the rest of the portfolio based on her or his investment outlook, rather than because the investor needs to raise cash. A MMF that fluctuates with the market cannot accomplish this strategic objective.

Lack of control over the timing of transactional and operational cash needs creates a need for stability as well. The number, frequency and variability of cash outlays make it impractical for people and companies to match these outlays to individual investments. A company with daily cash receipts could not realistically expect to invest this cash in instruments that would coincide with the due dates and amount of its bills.

Another cash management alternative would be to make longer-term investments and sell them in the secondary market to meet cash needs. This approach requires the investor to incur losses if she or he is forced to sell at an inopportune time. It also entails transaction costs that increase with the frequency of cash outlays. It is generally not efficient for an investor to take this approach, which is why investors have a decided preference for products that offer daily access to cash at a stable value.

The President's Working Group on Financial Markets' Report on Money Market Fund Reforms (the "PWG Report")[9] catalogued other reasons that investors need a stable NAV for cash management:

> [S]ome investors face functional obstacles to placing certain assets in floating NAV funds. For example, internal investment guidelines may prevent corporate cash managers from investing in floating NAV funds, some state laws allow municipalities to invest only in stable-value funds, and fiduciary obligations may prevent institutional investors from investing client money in floating NAV funds. In addition, some investors may not tolerate the loss of accounting convenience and tax efficiencies that would result from a shift to a floating NAV, although these problems might be mitigated somewhat through regulatory or legislative actions.[10]

In other words, some investors cannot legally invest in a floating NAV mutual fund. Federal and state laws or regulations, contracts, rating requirements or investment policies may impose such a restriction. The restriction often reflects the intended use of the cash invested. For example, bond indentures typically require the issuer to deposit cash needed for coupon or sinking fund payments in advance of the due date. An indenture trustee cannot afford to risk even a slight loss on such deposits, as it would lead to a payment default on the bonds.

For other investors, lack of control over when they receive and use cash leads to some of the tax and accounting issues referred to in the PWG Report. Whereas a shareholder might delay the purchase or redemption of a mutual fund held as an investment to avoid gains or losses due to a temporary fluctuation in its NAV, efficient cash management requires cash to be deposited as it is received and paid as obligations come due. A company cannot delay its employees' paychecks, for example, to avoid a loss due to a temporary fluctuation in the value of its MMF's shares.

Although the PWG Report identified the issue of tax reporting, it did not explain the tax problems inherent in using a fluctuating NAV fund for cash management. Currently, a MMF shareholder receives a Form 1099-DIV from the fund each year reporting the aggregate dividends the shareholder received. If the MMF had a fluctuating NAV, however, the shareholder would also have to receive a Form 1099-B reporting all of the shareholder's redemptions throughout the year. This could result in hundreds of redemptions being reported to a shareholder. Moreover, if any redemption resulted in a loss, and occurred within 30 days (whether before or after) of a purchase of shares, the loss would be disallowed as a "wash sale" and the shareholder would have to adjust the tax basis of the purchased shares. These tax reporting and record-keeping requirements make it impractical for many shareholders to use a floating NAV fund for cash management.

The accounting issues inherent in using a floating NAV fund for cash management are equally daunting. Such funds do not qualify for treatment as "cash equivalents," which will make a company appear less liquid in its financial reports and may cause it to violate loan covenants. A shareholder's financial reports would reflect unrealized as well as realized gains and losses.

Finally, the PWG Report overlooks the operational benefits of a stable NAV. It is easier and less costly to program a cash management system if the shares' value does not change.[11] This eliminates the need to track share lots and match them against redemptions. It allows the program to operate without waiting for transmission of a daily NAV from the fund. Additionally, the lack of a price variable reduces the risk of programing errors. This allows treasurers, trust departments and other active cash managers to integrate MMF shares into their normal cash management system, rather than the system used to track investments. The significant cost of reprograming an investment system to account for frequent transactions in a fund over the course of each day, and the difficulty of operating such a system, would deter shareholders from using MMFs. A stable NAV also reduces paperwork, insofar as Rule 10b-10(b)[12] does not require a stable value MMF to send a confirmation of each purchase and redemption, so long as the fund reports all of the shareholders' transactions in each regular account statement.

---

[1] FIMCO has waived, from time-to-time, a portion of the fees to which it was entitled or paid certain of POF's expenses in order for POF to provide a competitive return to its shareholders. FIMCO has not reimbursed POF, however, for any investment losses.

[2] Asset and portfolio information regarding POF is available at http://www.federatedinvestors.com/FII/daf/pdf/holdings_and_attribution/portfolio_holdings/money_market_funds/32233/32233_20121231.pdf?ctype=his.

[3] 8 *Money Fund Intelligence XLS - Top 10 Rankings*, No. 1 (Crane Data LLC Jan. 2013).

[4] Rule 18f-2, 17 C.F.R. § 270.18f-2, permits an open-end investment company to create separate mutual funds by issuing separate series of shares. Technically, MMOT is the investment company registered with the Commission, and POF is a series of shares issued by MMOT. POF shareholders' interests are limited to the portfolio acquired with proceeds from the sale of POF shares. Income from this portfolio is used to defray all the expenses of managing the portfolio, distributing and redeeming POF shares and other expenses incidental to POF's operation. Net income from the portfolio is distributed as dividends payable exclusively on POF shares. The shareholders of other series of MMOT have no rights to this portfolio or its income. POF is treated as an independent corporation for tax purposes.

POF offers four classes of shares in accordance with Rule 18f-3, 17 C.F.R. § 270.18f-3. Rule 18f-3 permits the issuance of separate classes of shares "hav[ing] a different arrangement for shareholder services or the distribution of securities" which "pay a different share of ... expenses" relating to such shareholder services and distribution arrangements. Unlike a series, each class represents an interest in the same portfolio and receives a proportionate share of the portfolio returns. Class specific expenses are deducted from the share of returns allocated to the class, so the net return to shareholders differs by class.

[5] These adjustments to accrued income also prevent MMFs from over or under distributing their income. By amortizing premiums to reduce income, the fund retains sufficient cash to compensate for the shortfall between the premium paid for the instrument and the amount received at maturity. By accreting discounts to increase income, the fund distributes sufficient cash to avoid realizing an apparent gain when the discount is paid at maturity.

[6] Daily dividends also play an important role in preventing dilution to shareholders. If a MMF allowed undistributed income to accrue while maintaining a stable NAV, shareholders who bought shares of the fund just before it declared a dividend would receive a share of the income previously earned without paying for it, at the expense of shareholders who held shares throughout the period the income was accrued.

[7] The Northern Trust Company Comment Letter to the Financial Stability Oversight Council at 2 (Jan. 14, 2013), http://www.regulations.gov/#!documentDetail;D=FSOC-2012-0003-0044.

[8] The source of the MMDA Rates is the Bank Rate Monitor.

[9] The PWG Report was published by the Commission for comment in ICA Release No. 29497, 75 Fed. Reg. 68636 (Nov. 3, 2010).

[10] *Id.* at 68468 [footnote omitted].

[11] The fact that a MMF may "break a dollar" does not affect normal cash management operations, insofar as an investor is unlikely to buy additional shares after such an event. Given that all shares will have been purchased for a dollar, the investor only needs to subtract the amount received upon redemption of the shares or liquidation of the fund to determine its losses after the fund breaks a dollar.

[12] 17 C.F.R. § 240.10b-10(b).

2. The Potential Impact of the FSOC Proposals on Prime Money Market Funds

The dockets for the PWG Report and the FSOC Proposals[1] provide a voluminous debate over whether MMFs pose a systemic risk to the U.S. financial system and, if so, whether the FSOC Proposals or other reforms could address the risk without imposing exorbitant costs and impairing capital formation. Rather than rehash this debate, we will instead use the information and analysis provided in the previous section to explain why each of the FSOC Proposals would threaten the continued viability of MMFs such as POF. The three alternative reforms under consideration in the FSOC Proposals are:

1. Requiring MMFs to have an initial NAV of $100 per share and to calculate a daily NAV based on the estimated market value of their portfolio to the nearest cent per share (the "Floating NAV Proposal");

2. Requiring MMFs (other than Treasury Funds) (a) to maintain a capital buffer equal to approximately 1% of their total assets and (b) to require shareholders in any type of MMF to maintain a minimum balance equal to 3% of their highest account balance during the preceding 30 days, which minimum balance would be subordinated to other shares to the extent of the shareholder's redemptions during such 30-day period (the "Minimum Balance at Risk Proposal"); and

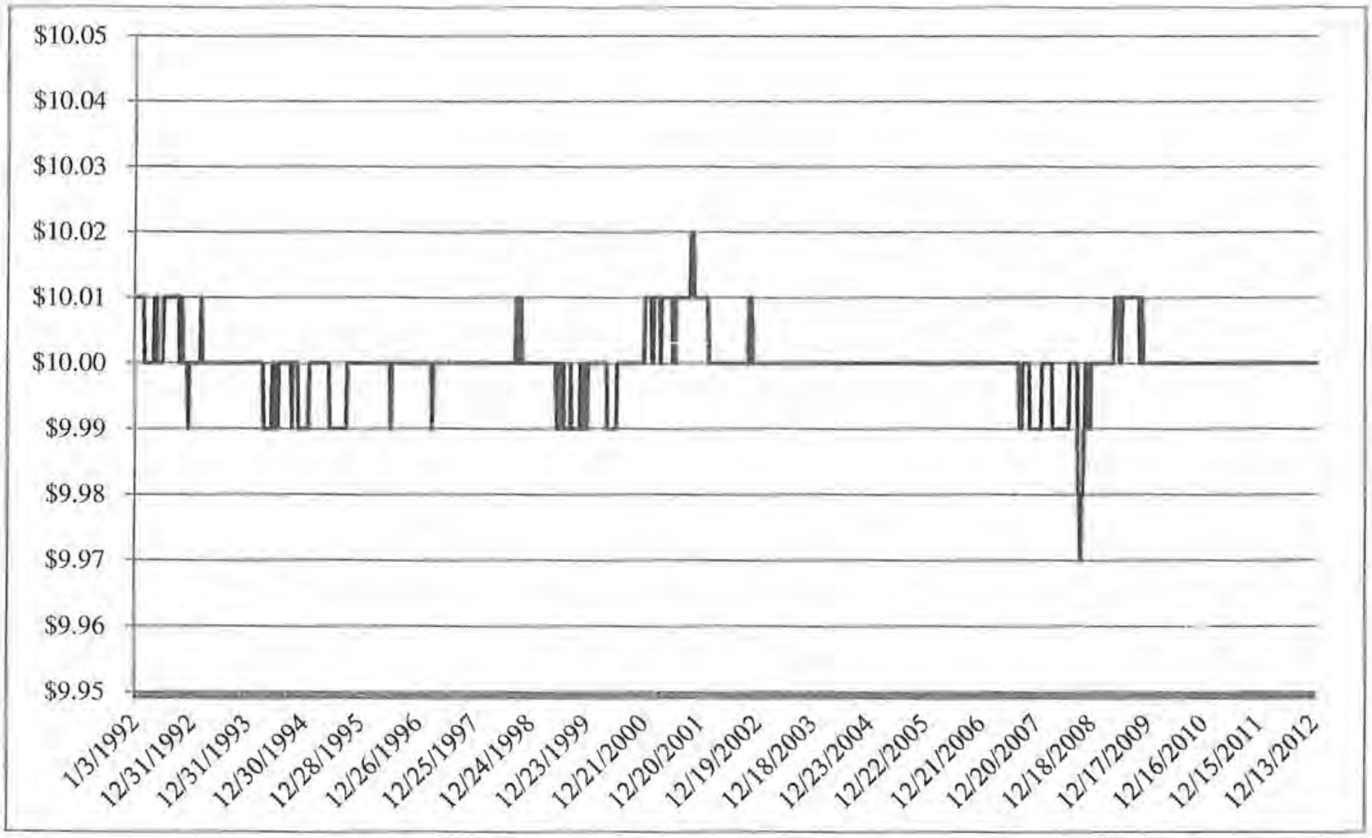
3. Requiring MMFs (other than Treasury Funds) to maintain a capital buffer equal to approximately 3% of their total assets and possibly become subject to more stringent risk constraints (the "Capital Proposal").

Given the importance of a stable NAV to efficient cash management, the fact that the Floating NAV Proposal would deter investors from MMFs should not surprise anyone. The Minimum Balance at Risk Proposal would have the same effect, because it would be even more cumbersome to operate than the Floating NAV Proposal. Finally, we show that the Capital Proposal is far too expensive for anyone to implement.

2.1 Impact of the Floating NAV Proposal on POF

Even if a MMF calculated its NAV like other mutual funds, its NAV would remain completely stable under ordinary market conditions. Chart 4 shows what POF's share price would have been had it valued its shares like other mutual funds: using a base price of $10 rounded to the nearest cent.* Chart 4 (which is on the same scale as Chart 2) shows that POF would have sustained a continuous $10 NAV for years at a time, including a period of nearly five years from November 2002 through August 2007. In fact, during the entire period of 1992 through 2012, the NAV would have been $10 for 80% of the period.

Chart 4
Shadow Price Using a $10 NAV



The infrequent, temporary and trivial (with one exception, only a penny) fluctuations in POF's NAV would have produced major problems for its shareholders, however. For example, if a shareholder were unfortunate enough to redeem shares during any of the one-week periods that the NAV was $9.99 (e.g., December 4, 1992, July 5, 1996 or March 27, 1997), the shareholder would have to realize a loss on the redeemed shares. Moreover, if the shareholder purchased shares within 30 days before or after the redemption, the redemption would be a "wash sale" and the shareholder would have to add the loss to the basis of the purchase shares. A meaningless blip in the

* Chart 4 overstates the hypothetical volatility of POF's share price, because it does not use amortized cost to value obligations with remaining maturities of 60 days or less, as other mutual funds are permitted to do. *See*, *infra* Subsection 3.1.

share price would produce an enormous tax and recordkeeping headache for the shareholder.

Chart 4 also shows how a floating NAV creates accounting headaches even for shareholders who do not redeem their shares. Any company that held shares on March 31, 1997 would have to write down the shares by a penny in the first quarter financial statements. Such companies would then write the shares back up in the second quarter financial statements, when the NAV returned to $10.

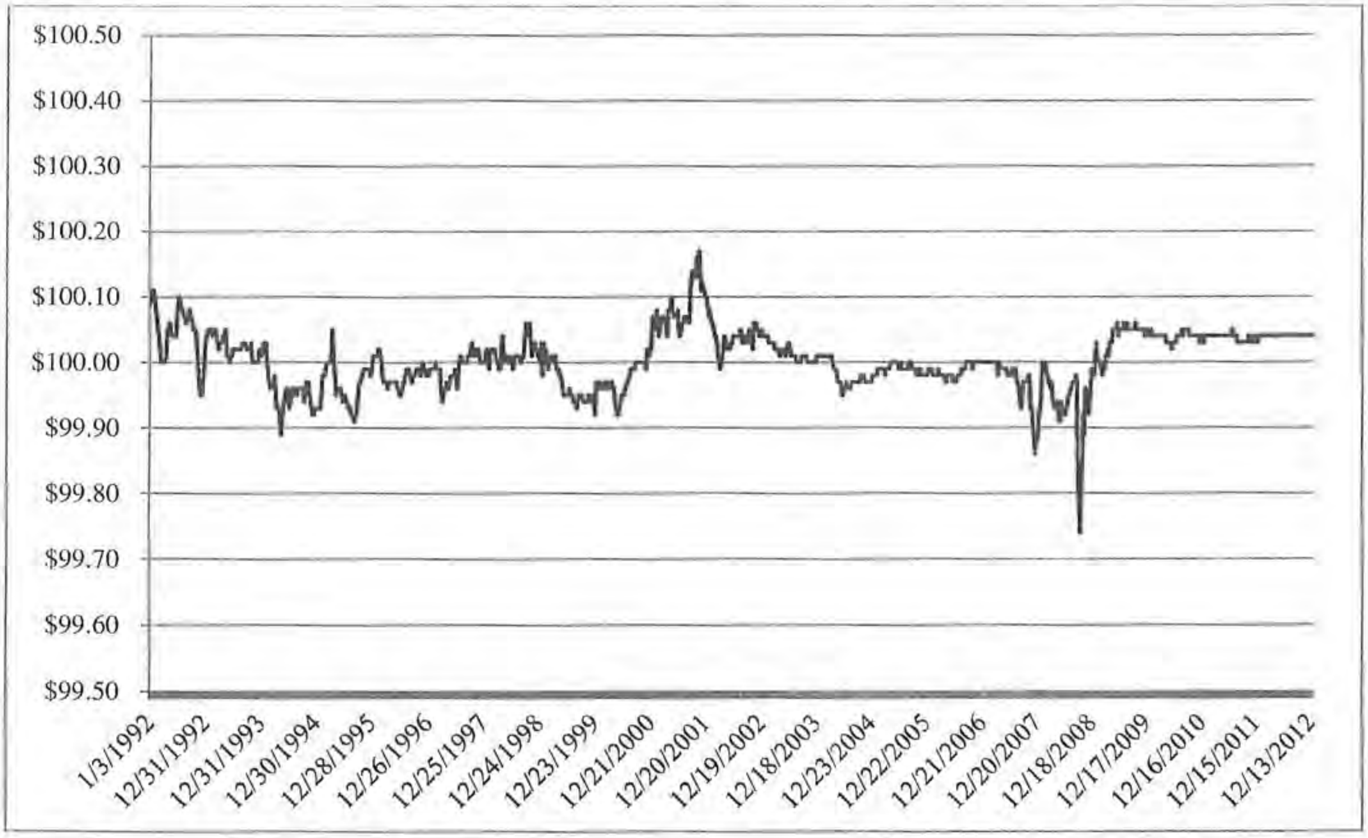
Periods where the NAV bounces between $10 and $9.99 (such as in the last half of 1999, when the NAV changed 12 times from $10 to $9.99 and back again) are even worse from a shareholder's perspective. These periods occur when the NAV is close to $9.995 and tiny changes in value (tenths of a basis point) cause the NAV to round up or down. During such periods, shareholders could not avoid buying and redeeming shares at different values, which would force them to track share lots, report gains and losses and account for numerous wash sales. It is hard to imagine shareholders continuing to use POF for cash management after experiencing one of these periods.

Chart 4 simply multiplies POF's shadow price by 10 and rounds to the nearest cent, so it does not model the actual effects of purchasing and redeeming shares at a floating NAV. For example, when the NAV is rounded down to $9.99, net redemptions will tend to drive the NAV back to $10, as the net assets attributable to rounding are divided by a smaller share base. Someone even might try to arbitrage the rounding effect shown in the last half of 1999, buying in whenever the NAV drops to $9.99 and selling when it returns to $10. (Of course, such arbitrage is not possible when a fund maintains a stable share price.) Thus, the difficulties that a floating NAV creates for cash management may be more significant than Chart 4 suggests.

Of course, the Council has not merely proposed to require MMFs to calculate their NAV in the same manner as other mutual funds. The Floating NAV Proposal would require MMFs to calculate a mandatory $100 NAV to the nearest penny, which would be a tenfold increase in the standard of accuracy as compared to other mutual funds. Chart 5 on the following page shows what the price of POF's shares would have been under the Floating NAV Proposal for the period from 1992 through 2012.[2]

Chart 5 (which is on the same scale as Chart 2) shows that, under the Floating NAV Proposal, shareholders could expect POF's NAV to change nearly every week. Each change would create all of the legal, tax, accounting and operational problems just discussed. The changes would not be meaningful, however; a shareholder would have to redeem over $10,000 before these fluctuations in POF's NAV would amount to a gain or loss of more than $1. By magnifying minuscule changes (less than one-tenth of one basis point) in value to a point where they change a fund's NAV, the Floating NAV Proposal would maximize the difficulty of using a MMF without any offsetting benefit to its shareholders.

Chart 5
Shadow Price Using $100 NAV



The Floating NAV Proposal would have far-reaching effects on the utility of MMFs. Current applications of MMFs that could not operate with a floating NAV include:

- Corporate payroll processing,
- Operating cash for businesses, governmental units and other enterprises,
- Personal trust and fiduciary accounts,
- Accounts maintained for temporary investment of bond and securitization proceeds and payment funds,
- Escrow processing,
- Pension plan processing,
- Customer cash and sweep balances with broker/dealers and futures dealers, and
- Cash collateral for securities lending, derivative contracts and clearing organizations.

The Floating NAV Proposal would also greatly increase the burden on intermediaries that maintain omnibus accounts on behalf of their clients. These intermediaries are responsible for providing annual tax reports to their clients, which would require them to track and report all their clients' MMF transactions. In addition, Rule 10b-10 would require broker-dealers to send confirmations of every client purchase or redemption of MMF shares. Intermediaries could avoid these recordkeeping and reporting burdens by shifting cash held in omnibus accounts to bank accounts or other alternative cash investments, so they are likely to stop offering MMFs to their clients. POF currently has over 1300 omnibus accounts holding over 70% of its shares, so any shift by these intermediaries to other products would have serious repercussions for the fund.

The Commission has received scores of comment letters from shareholders confirming that they will no longer use MMFs if they float their NAVs. The Commission first solicited comments on a floating NAV for MMFs in connection with the 2010 Amendments, and received an overwhelmingly negative response from MMF shareholders.[3] The Commission received the same response from shareholders to the floating NAV alternative discussed in the PWG Report, as has the Council in response to the Floating NAV Proposal. There is no evidence to support the view that a substantial portion of POF's current shareholders would remaining in the fund if the Commission adopted the Floating NAV Proposal, and overwhelming testimony by shareholders to the contrary.

The Council admits that the Floating NAV Proposal "would present certain federal income tax issues for MMFs and their investors," that "[t]here are also accounting considerations relating to floating-NAV MMFs," and that the "current ability to transact at a stable NAV also generates other operational efficiencies that may be lost with a floating NAV."[4] The FSOC Proposals offer no solutions for these problems, apart from vague indications from the Treasury Department and Internal Revenue Service:

> that they will consider the extent to which expansion or modification of basis reporting could help shareholders deal with floating-NAV MMFs, [and] they will evaluate the possibility of some administrative relief from the wash sale rules for *de minimis* losses on floating-NAV MMF shares.[5]

Contrary to the statements in the FSOC Proposals, it has been reported that in meetings with members of the IM Division, "IRS officials have told the securities regulator that they don't have much flexibility to interpret current tax law ...."[6] Unless solutions to these tax and accounting problems are found and implemented before switching to a floating NAV, the natural consequence of adopting the Floating NAV Proposal will be to drive shareholders out of money market funds and into bank accounts or other investment alternatives.

Resolution of these tax and accounting problems will not help shareholders who are legally restricted from using floating NAV funds or affect the operational convenience of a stable NAV. Thus, there would still be a demand for stable NAV MMFs even after the implementation of tax and accounting reforms. The extent of this potential demand cannot be assessed without some idea of effects of these reforms. Clearly, a concrete tax proposal from the Treasury and the IRS should be the next step in the reform process, rather than a recommendation of the Floating Rate Proposal.

2.2 Impact of the Minimum Balance at Risk Proposal on POF

The next subsection will address the capital this proposal would require, so that this subsection can focus on the minimum balance requirement. The insurmountable problem with this proposal is its complexity. Detailing the legal and operational problems with the Minimum Balance at Risk Proposal would require more than the 79 pages originally used by the staff of the New York Federal Reserve Bank to describe the proposal.[7] The following schematic description of the steps required to implement a minimum balance requirement should convey, however, the stultifying complexity of the requirement.

In order for POF or any MMF to implement the Minimum Balance at Risk Proposal:

1. On *every* business day, the balances of *every* shareholder account from the preceding 30 days must be reviewed to determine the highest daily balance during the period. Then the excess (if any) of this amount over $100,000 must be calculated, which excess represents each account's "High Water Mark."

2. The minimum balance requirement ("MBR") for each account must be calculated by multiplying the account's High Water Mark by 3%.

3. Before any redemption is processed, it must be tested to determine whether it would cause the account balance to fall below its MBR. If the redemption fails the test, then the redemption must be separated into two orders, one order for the account balance in excess of the MBR that can be processed in the regular way, and a second for the balance of the redemption that must be held over and processed 30 days later.

4. Regardless of whether the redemption passes or fails the MBR test, the subordinated portion of the account balance must be calculated using the following formula:

MBR × (High Water Mark − current balance) ÷
(High Water Mark − MBR).[8]

5. If the fund incurs a loss, it must allocate the loss, *pro rata*, first, to the subordinated portion of each account balance, second, to the remaining MBR of each account, and last, to the account balances in excess of the MBR.

Every financial intermediary that maintains shareholder accounts would have to follow this process, not just the fund and its transfer agent. The Council tries to suggest that compliance by financial intermediaries would be voluntary,[9] but this ignores the requirements of state laws. Under the Uniform Commercial Code, an intermediary that maintains a securities account must "exercise rights with respect to a financial asset [e.g., redeem a MMF share] if directed to do so by an [account] holder."[10] Under the Minimum Balance at Risk Proposal, an intermediary's right to redeem shares from its omnibus account with a MMF would be limited by the intermediary's MBR. If the intermediary allowed its underlying account holders to redeem without limit, the intermediary could find itself unable to exercise an account holder's right to redeem shares because redemptions by other account holders had used up the unrestricted balances in the omnibus account. This would violate the intermediary's obligations under the Uniform Commercial Code, in addition to unfairly placing the entire burden of the omnibus account MBR on its remaining account holders.

As previously noted, over 70% of POF's shares are currently held in over 1300 omnibus accounts. It defies common sense to suppose that these intermediaries would make the complex operational changes necessary to implement a minimum balance requirement when simpler cash management investments (such as bank accounts) are available. Even if intermediaries were willing to do so, there is no reason to suppose that shareholders would tolerate such byzantine restrictions on their cash, which would make it difficult to know what their MBR and subordinate balances are from day to day. It is therefore not surprising that comments from transfer agents, intermediaries and shareholders to the Minimum Balance at Risk Proposal have been strongly and uniformly negative. The Minimum Balance at Risk Proposal would transform a simple and useful investment product into a complex morass no one would want to deal with.

2.3 Impact of the Capital Proposal on POF

The Capital Proposal would impose a capital requirement based on the following formula:

- No capital required for cash, Treasury securities and repurchase agreements for Treasury securities;

- Other Daily Liquid Assets would be subject to a capital requirement of 2.25%; and
- All other assets would be subject to a capital requirement of 3%.

The Minimum Balance at Risk Proposal would include capital requirements at one-third of these levels (i.e., 0.75% for Daily Liquid Assets and 1% for other assets).

A MMF could satisfy the capital requirement through any combination of:

- Retained earnings (treating any net asset value above $1 per share as capital);
- Issuing equity securities subordinate to the fund's redeemable securities; and
- An escrow account holding only Weekly Liquid Assets established by the fund's sponsor for support of the fund.

Failure to meet these capital requirements would restrict a MMF from making new investments in anything other than Treasury securities or repurchase agreements for Treasury securities.

POF provides a ready illustration of the impracticality of capital requirements under current market conditions. Table 6 shows what POF's capital requirement would have been if the Capital Proposal had been in effect on December 31, 2012.

Table 6
Capital Requirement as of 12/31/2012

Class of Assets	Amount of Portfolio	Capital Requirement	Required Capital
Cash, Treasuries, etc.	$495,943,602	0.00%	$0
Other Daily Liquid Assets	$10,180,994,972	2.25%	$229,072,387
Other Assets	$37,780,423,461	3.00%	$1,133,412,704
TOTAL	$48,457,362,035		$1,362,485,091

Table 7 compares this over $1.3 billion capital requirement to POF's total investment income, the total dividends paid to POF's shareholders and the adviser's fees (net of waivers and reimbursements) paid by POF to FIMCO, in each case for the fiscal year ended July 31, 2012. The final column shows the capital requirement as a percentage of earnings, dividends and net adviser's fees, respectively.

Table 7
Capital Requirement for POF Compared to Fund, Shareholder and FIMCO Earnings in Fiscal 2012[11]

Capital Requirement	$1,362,485,091	
Investment Income	$183,128,331	744%
Dividends	$72,757,230	1873%
Adviser's Net Fees	$46,053,106	2959%

Table 7 shows that the Council's proposed capital requirement exceeds seven times the entire amount of POF's investment income. If POF never paid another penny in dividends, it would take over 18 years to retain sufficient earnings to satisfy the capital requirement. This demonstrates that POF could not possibly retain enough earnings to continue operating as a prime fund under the capital proposal.

With respect to subordinated equity, the Council's economic analysis assumed that a fund would have to pay providers of subordinated equity a 5% premium over the yield on the fund's redeemable shares.[12] Even if we accept this absurdly low figure for equity that would bear all fund losses in perpetuity, the annual cost to POF of subordinated equity equal to the capital requirement would have been $70,440,479, leaving only $2,316,751 to pay in dividends to the other shareholders. There is no reason to expect POF's current shareholders to accept an arrangement where they provide over 97% of the capital and receive only 3% of the net earnings.

This leaves Federated as the only remaining potential source of capital. As POF's capital requirement equals nearly 30 years of net adviser's fees, Federated would have to borrow money to fund an escrow account. The agent for Federated's current loan facility has estimated that it would charge an upfront fee of approximately $7.5 million for a five-year loan of $1.3625 billion, which would bear interest at a current rate of 2.25% per annum.* At this rate, annual debt service on the loan would be approximately $30.7 million. Based on these estimates, in the first year the cost of borrowing the escrow that the Capital Proposal would require for POF would total over 82% of the net adviser's fees received for managing the fund. Federated could not possibly incur such an enormous expense and continue to profitably manage POF.

Even if Federated could afford these costs, it would be unlikely that Federated, which has a market capitalization of less than $2.5 billion, could borrow the additional billions required to fund the escrows for Federated's 17 other non-Treasury Funds, which held assets of over $172.5 billion at the end

* This interest rate is based on LIBOR, and would therefore increase directly with any increase in LIBOR. This means that any increase in POF's investment income that might result from a reversal of the Federal Reserve's low interest rate policies and allow FIMCO to reduce its fee waivers would be offset by an increase in the cost of servicing the loan.

of 2012. It is financially impossible for Federated, or most other MMF managers, to provide the capital that would be required by the Capital Proposal and still make a profit from managing their funds.

Clearly, prime MMFs cannot afford the capital required by the Capital Proposal, nor can their shareholders or advisers. Even the lower level of capital required under the Minimum Balance at Risk Proposal would be prohibitive, as it would still represent over two years of POF's investment income, six years of dividends and nearly 10 years of net adviser's fees. Thus, the Capital Proposal, like the Floating NAV and Minimum Balance at Risk Proposals, would spell the end of prime MMFs.

---

[1] Comments on the PWG Report are available at http://www.sec.gov/comments/4-619/4-619.shtml. Comments on the FSOC Proposals are available at http://www.regulations.gov/#!docketDetail;D=FSOC-2012-0003.

[2] As with Chart 4, Chart 5 overstates the volatility of POF's NAV because it does not value obligations with remaining maturities of 60 days or less at their amortized cost. In fact, Chart 5 depicts the version of the Floating NAV Proposal advocated by the 12 Presidents of the Federal Reserve Banks, http://www.regulations.gov/contentStreamer?objectId=09000064811f5c44&disposition=attachment&contentType=pdf, who would require MMFs to estimate the market value of all their assets, regardless of maturity, as well as to calculate an initial $100 NAV to the nearest cent.

[3] Money Market Fund Reform, ICA Release No. 28807, 74 Fed. Reg. 32688, 32716-18 (proposed June 30, 2009). Comments are available at http://www.sec.gov/comments/s7-11-09/s71109.shtml.

[4] FSOC Proposal, *supra* Executive Summary, note 4, at 69467-68.

[5] *Id.* at 69467.

[6] Christopher Condon & Dave Michaels, *SEC Said to Discuss Floating NAV for Money Funds with IRS*, BLOOMBERG (Mar. 7, 2013), http://www.bloomberg.com/news/2013-03-06/sec-said-to-discuss-floating-nav-for-money-funds-with-irs.html.

[7] Patrick E. McCabe, Marco Cipriani, Michael Holscher and Antoine Martin, *The Minimum Balance at Risk: A Proposal to Mitigate the Systemic Risks Posed by Money Market Funds*, Staff Report No. 564 (July 2012), http://www.newyorkfed.org/research/staff_reports/sr564.pdf. Operational issues involved in the Minimal Balance at Risk Proposal were described in DST Systems, Inc. Comment Letter to the Commission (Mar. 2, 2012), http://www.sec.gov/comments/4-619/4619-128.pdf, Arnold & Porter LLP Comment Letter to the Commission on behalf of Federated Investors, Inc. (Feb. 24, 2012), http://www.sec.gov/comments/4-619/4619-122.pdf, and Federated Investors, Inc. Comment Letter to the Commission (Mar. 16, 2012), http://www.sec.gov/comments/4-619/4619-140.pdf.

[8] FSOC Proposals, *supra* Executive Summary, note 4, at 69471 n. 94.

[9] *Id.* at 69471 n. 99.

[10] U.C.C. § 8-506.

[11] Federated Prime Obligations Fund Annual Shareholder Report (as of July 31, 2012) at 19-20.

[12] FSOC Proposal, *supra* Executive Summary, note 4, at 69480.

3. History of Money Market Fund Regulation

Discussions of possible MMF reforms should be grounded on an understanding of the provisions of the ICA that govern the calculation of a mutual fund's NAV and the limited exemption provided by Rule 2a-7 for valuing MMF portfolios at amortized cost. It is also helpful to be familiar with the steps that led the Commission to grant this exemption. A review of this history reveals that the Federal Reserve's current position on MMF reform is largely a reiteration of its initial response to the Commission's decision to grant the exemption. History also confirms that soundness of the Commission's decision, particularly as only two MMFs have broken a dollar in the subsequent 34 years.

Money market funds are a type of open-end investment company, also known as a mutual fund. The distinguishing feature of a mutual fund is the issuance of "redeemable securities,"[1] defined as a securities "under the terms of which the holder, upon its presentation to the issuer ..., is entitled ... to receive approximately his proportionate share of the issuer's current net assets, or the cash equivalent thereof."[2] Rule 2a-4, which governs calculations of the "current net asset value of any redeemable security issued by a registered investment company," provides that:

> Portfolio securities with respect to which market quotations are readily available shall be valued at current market value, and other securities and assets shall be valued at fair value as determined in good faith by the board of directors of the registered company.[3]

"Market quotations are not readily available for many money market instruments in [money market] funds' portfolios because they are generally held to maturity, thereby eliminating a meaningful secondary market."[4] The absence of market quotations led the Boards of many MMFs to fair value money market instruments at their amortized costs. Other MMFs, known as "penny rounding funds," calculated their NAV using "quotes" that were "merely estimates of the instruments' market value with reference to current money market rates ...."[5] As their name suggests, penny rounding funds offered their shares for a price of $1.00 and then calculated their NAVs each day, rounding the price to the nearest cent. The penny rounding method helps maintain a stable NAV by making the share price less sensitive to changes in the estimated market value of the fund's portfolio.[*]

[*] Traditionally, mutual funds offer their shares at an initial price of $10.00 and calculate their daily NAV to the nearest cent. Under these circumstances, a change of 0.05% or more in the value of the portfolio will result in a change in the NAV. If the initial share price is $1.00, however, the value of the portfolio must fluctuate by at least 0.50 % to change an NAV calculated to the nearest cent. In other words, a fund with a $1.00 NAV using the penny

3.1 The Commission's Standards for Valuation: ASR 219

In 1975, the Commission raised concerns regarding the use of amortized cost to fair value securities, indicating that it was "undesirable to determine value by a mechanical or automatic formula with no reference to market value and no judgmental input on the part of the directors."[6] The Commission asked for comments on an interpretation of the ICA that would discontinue the use of amortized cost as a method of fair valuing securities.

After reviewing comments on the proposed interpretation, the Commission issued a final interpretive release (Accounting Series Release No. 219, or "ASR 219") in May 1977. The Commission concluded:

> [1] [I]t shall prospectively consider it inconsistent with the provisions of Rule 2a-4 for a money market fund to determine the fair value of debt securities which mature at a date more than 60 days subsequent to the valuation date on an amortized cost basis.
>
> ...
>
> [2] [M]oney market funds ... should value debt securities with greater than 60 days remaining to maturity based upon current market quotations if readily available or, if such quotations are not readily available, in such a manner as to take into account any unrealized appreciation or depreciation due to changes in interest rates and other factors which would influence the current fair values of such securities.
>
> ...
>
> [3] [A]ny money market fund which reflects capital changes in its net asset value per share should calculate, and utilize for purposes of sales and redemptions, a current net asset value per share with an accuracy of one-tenth of one percent (equivalent to the nearest one cent on a net asset value of $10.00).[7]

The second conclusion prevented a MMF from continuing to use the amortized cost method to value its entire portfolio. The third conclusion prevented a MMF from continuing to use the penny rounding method to calculate its NAV. Funds were to begin complying with the Commission's interpretation by November 30, 1977.

3.2 Orders Exempting Money Market Funds from ASR 219

Most MMFs responded to ASR 219 by filing applications for exemptive orders that would permit the funds to continue utilizing either the penny

---

rounding method is one-tenth as sensitive to changes in the value of its portfolio as a fund with a traditional initial $10.00 NAV.

rounding or the amortized cost method.[8] Federated was among the companies that filed an application, and the Commission issued a notice proposing to grant Federated an exemptive order in October 1977.[9] Two managers for penny rounding funds requested that the Commission hold hearings on the amortized cost funds' applications, so the Commission granted Federated and the other applicants a temporary exemption until it determined to hold hearings.[10]

In April 1978, the Commission issued an order for a consolidated hearing on the applications for penny rounding as well as for amortized cost funds.[11] The penny rounding funds reached an agreement to amend their applications and received exemptive orders from the Commission before the hearings began.[12] An administrative law judge conducted hearings on the amortized cost applications from November 1978 into March 1979. Federated defended its application in the hearings, which included 12 days of testimony. After the hearings were completed and the judge strongly encouraged the Commission to reach a settlement, the applicants, those who requested the hearing and the Commission agreed to an order granting the funds' applications, subject to the following conditions.[13]

1. The Board undertook—as a particular responsibility within the overall duty of care owed to its shareholders—to establish procedures reasonably designed, taking into account current market conditions, to stabilize the fund's NAV per share, as computed for the purpose of distribution, redemption, and repurchase, at $1.00 per share.

2. The procedures adopted by the Board would include:

    a. Review by the Board, at such intervals as are reasonable in light of current market conditions, to determine the extent of deviation, if any, of the shadow price from the $1.00 amortized cost price per share.

    b. In the event such deviation from the $1.00 amortized cost price per share exceeded 0.5%, the Board would promptly consider what action, if any, should be initiated.

    c. Where the Board believed the extent of any deviation from the $1.00 amortized cost price per share may result in material dilution or other unfair results to investors or existing shareholders, the Board would take such action as it deems appropriate to eliminate or to reduce to the extent reasonably practicable such dilution or unfair results.

3. The fund would maintain a dollar-weighted average portfolio maturity ("WAM") appropriate to its objective of maintaining a stable NAV per share; provided, however, that the fund would not (a) purchase any instrument with a remaining maturity of greater than one year, or (b) maintain a WAM in excess of 120 days.

4. The fund would limit its portfolio investments, including repurchase agreements, to those instruments which the Board determined presented minimal credit risks, and which would be of high quality as determined by any major rating service or, in the case of any instrument that is not so rated, of comparable quality as determined by the Board.

This release provided the template for nearly 100 subsequent exemptive orders, mostly permitting use of the amortized cost method to calculate a MMF's NAV.[14]

3.3 The Federal Reserve's Response to Money Market Funds

The Federal Reserve had a negative reaction to the introduction of MMFs. An early manifestation of its opposition to MMFs was the Federal Reserve's imposition of reserve requirements for MMFs. Funds were required to deposit with a Federal Reserve Bank 15% of the amount by which their "covered credit" exceeded the amount of covered credit held as of March 14, 1980. Covered credit was defined as "any extension of credit originated through the acquisition of a security, deposit or other instrument." Although the reserve requirements were purportedly a measure "to moderate and reduce inflationary forces in the United States economy,"[15] their effect was to reduce the competitive pressure MMFs applied to banks, by allowing a MMF to earn interest on only 85% of the cash added to the fund after March 14, 1980.

The industry responded to the reserve requirement by creating new funds or new classes of shares for investments made after March 14, so that existing shareholders would not suffer a reduction in their yields. In April 1980, the Commission adopted temporary regulations designed to facilitate the creation of such new funds and classes without obtaining an exemptive order or amending an existing order.[16] The Federal Reserve reduced the deposit requirement to 7.5% in June, and eliminated the requirement entirely on July 3, 1980.[17]

In 1981, the Chairman of the Federal Reserve Board asked Congress to pass legislation that "would make [MMFs] more competitive with banking institutions and less attractive to investors." Specifically,

> In an address ... to the Domestic Monetary Policy Subcommittee of the House Banking Committee, ... Mr. Volcker said that

money funds that offered check-writing privileges and other transaction services should be subject to the same type of reserve requirements as banks.

> That would mean that fund managers would have to set aside a portion of their assets in non-interest bearing reserves rather than investing them.
>
> . . .
>
> The Fed chairman also proposed that, where money funds were not subject to reserves, investors would either have to give prior notification before making withdrawals or be required to leave funds on deposit for some fixed or minimum maturity.[18]

The Commission opposed the proposed legislation, testifying: "we believe that the existing framework of regulation applicable to money market funds provides appropriate investor protection and that imposing additional, bank-type regulation on those funds would harm the interests of investors without corresponding benefits to them."[19] Alan Greenspan also criticized the proposal, explaining:

> The money market funds hold assets (close to cash) that would be considered reserves by other institutions. You could say that they are in a 100 percent reserve situation. The proposal to put a reserve requirement on MMFs is designed arbitrarily to restrict their competitive position. There is no economic rationale for it (that is, in terms of safety for the depositor). The idea of a reserve is to facilitate the conversion of assets. But what the MMFs hold is all rather liquid.[20]

Congress did not act on Chairman Volcker's proposals.

The Federal Reserve Board's opposition to MMFs lay largely dormant until after the financial crisis, when former Chairman Volcker again called for restrictions on MMFs. As before, he appeared motivated more by concern for banks than concern for the needs of investors: "In my vision of the new financial system, you obviously want to protect banks and have strong banks, and I don't think they should be put at a competitive disadvantage vis-à-vis money-market funds."[21] His comment at the Commission's Roundtable on Money Market Funds and Systemic Risk was also illuminating. On being told there were 650 MMFs, Volcker replied "650? This country could use 650 more banks. We just lost about 1,000 during the crisis."[22]

3.4 Adoption and Amendment of Rule 2a-7

In 1982, the Commission proposed to codify the terms and conditions of its MMF exemptive orders in a new exemptive rule: Rule 2a-7.[23] The proposed conditions of Rule 2a-7 were virtually identical to the conditions of the exemptive orders being issued at that time, except for additional provisions clarifying how a fund's WAM should be calculated.

The Commission adopted Rule 2a-7 on July 11, 1983.[24] The rule was adopted substantially as proposed, although certain conditions and definitions were expanded. In addition, the Commission provided guidance regarding the Board's responsibilities under the rule in the adopting release. For example, the Commission advised that, "when a fund purchases illiquid instruments, the board of directors has a fiduciary duty to ascertain that the fund is operated in such a manner that the purchase of such instruments does not materially affect the valuation of the fund's shares."[25]

Rule 2a-7 has undergone four major revisions.[26] Each of these reforms resulted from the cooperative efforts of the staff of the Commission and industry representatives, particularly the industry's trade association, the ICI. Although there has not been uniform agreement on every provision of Rule 2a-7, the industry has consistently supported proposed reforms aimed at increasing the resilience of MMFs and informing their shareholders of material risks. Leaders in the industry, including Federated, have always acknowledged the importance of protecting MMF shareholders through appropriate regulation and disclosure.

The 2010 Amendments exemplify the cooperative efforts of the staff and the industry in adopting important reforms. Immediately following the financial crisis in 2008, the ICI organized a Money Market Working Group (which included Federated) to study and propose regulatory reforms for MMFs. In March 2009, the ICI released the Working Group's recommendations.[27] Just three months later, the Commission proposed reforms based, in large part, on these recommendations.[28] The Commission approved final amendments in February 2010, most of which took effect May 31, 2010. This was months before enactment of the DFA, and may be regarded as the first substantive regulatory reform implemented by any federal agency after the financial crisis.

---

[1] ICA § 5(a)(1), 15 U.S.C. § 80a-5 (a)(1). ("'Open-end company' means a management company which is offering for sale or has outstanding any redeemable security of which it is the issuer.")

[2] ICA § 2(a)(32), 15 U.S.C. § 80a-2 (a)(32).

[3] 17 C.F.R. § 270.2a-4(a)(1). Rule 2a-4 incorporates the definition of "value" provided by ICA § 2(a)(41)(B), 15 U.S.C. § 80a-2 (a)(41)(B).

[4] Valuation of Short Term Debt Instruments Owned by Registered Investment Companies Including Money Market Funds, ICA Release No. 8757, 40 Fed. Reg. 18467, 18468 (proposed Apr. 15, 1975).

[5] *Id.*

[6] *Id.*

[7] Valuation of Debt Instruments by Money Market Funds and Certain Other Open-End Investment Companies, ICA Release No. 9786, Accounting Series Release No. 219, 42 Fed. Reg. 28999, 29000-01 (adopted May 31, 1977). ASR 219 is included in the Codification of Financial Reporting Policies at §404.05.

[8] ICA § 6(c), 15 U.S.C. § 80a-6 (c), gives the Commission power, "by order upon application, [to] conditionally or unconditionally exempt any person, security, or transaction, or any class or classes of persons, securities, or transactions, from any provision or provisions of this title or of any rule or regulation thereunder, if and to the extent that such exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of this title."

[9] Money Mkt. Mgmt., Inc., *et. al.*, Filing of Application for Order of Exemption, ICA Release No. 9967, 42 Fed. Reg. 56821, 18468 (notice issued Oct. 21, 1977).

[10] Money Mkt. Mgmt., Inc., *et. al.*, Notice and Order of Temporary Exemptions, Pursuant to Section 6(c) of the Act, From the Provisions of Section 2(a)(41) of the Act and Rules 2a-4 and 22c-1 thereunder, ICA Release No. 10027, 42 Fed. Reg. 61340 (issued Nov. 28, 1977).

[11] Intercapital Liquid Asset Fund, Inc., *et. al.*, Filing of Application for Order of Act Granting Exemptions and Order for Hearing on Applications of Act for Exemptions, 43 Fed. Reg. 16830 (issued Apr. 19, 1978).

[12] Daily Income Fund, Inc., Notice of and Order Cancelling Hearing and Granting Amended Applications for Exemptions from Rules 2a-4 and 22c-1 under the Act, ICA Release No. 10451, 43 Fed. Reg. 51485 (issued Oct. 26, 1978).

[13] Intercapital Liquid Asset Fund, Inc., *et. al.*, Order Granting Applications for Exemptions from Section 2(a)(41) of the Act and Rules 2a-4 and 22c-1 thereunder to Permit the Use of Amortized Cost Valuation, and Cancelling Hearing on Such Applications, ICA Release No. 10824, 18 SEC Docket 52 (issued Aug. 8, 1979).

[14] After the initial exemptive order, "more than 90 MMFs ... requested, and the Division pursuant to delegated authority has granted, exemptive relief to permit the use of amortized cost valuation, subject to substantially the same conditions as those contained in the original order settling the hearing. Certain minor changes were made in subsequent orders to reflect technical corrections. In addition, subsequent orders permitting amortized cost valuation as well as penny rounding were issued based upon applications that reflected a broader range of permissible portfolio investments." Valuation of Debt Instruments and Computation of Current Price per Share by Certain Open-End Investment Companies (Money Market Funds), ICA Release No. 12206, 47 Fed. Reg. 5428, 5429 (proposed Feb. 1, 1982).

[15] Effect of Credit Controls on the Operations of Certain Registered Investment Companies Including Money Market Funds, ICA Release No. 11088, 45 Fed. Reg. 17954 (issued Mar. 14, 1980).

[16] Temporary Rule Providing Exemptions to Certain Money Market Funds and Other Persons and Companies, ICA Release No. 11137, 45 Fed. Reg. 28307 (issued Apr. 22, 1980).

[17] Federal Reserve Board Release, [1979-80 Trans. Binder] Fed. Banking L. Rep. (CCH) ¶98,346 (July 25, 1980).

[18] *Volcker Proposes Money Funds Be Subject To Rules On Reserves*, N.Y. TIMES, June 26, 1981, at D3.

[19] *S.E.C. Says It Opposes Curbs on Money Funds*, N.Y. TIMES, Apr. 9, 1981, at D7.

[20] *Saver' Bill Is Anything But*, WASH. POST, July 5, 1981, at E1.

[21] *Ex-Fed Chief Attacks Money-Market Funds*, DAILY TELEGRAPH, Aug. 26, 2009, at City 1.

[22] Unofficial Transcript: Roundtable on Money Market Funds and Systemic Risk (May 10, 2011), http://www.sec.gov/spotlight/mmf-risk/mmf-risk-transcript-051011.htm.

[23] ICA Release No. 12206, *supra* note 14, at 5429.

[24] Valuation of Debt Instruments and Computation of Current Price per Share by Certain Open-End Investment Companies (Money Market Funds), ICA Release No. 13380, 48 Fed. Reg. 32555, 32556 (adopted July 11, 1983).

[25] *Id.* at 32562.

[26] Acquisition and Valuation of Certain Portfolio Instruments by Registered Investment Companies, ICA Release No. 14983, 51 Fed. Reg. 9773 (adopted Mar. 12 1986) (the "1986 Amendments"); Revisions to Rules Regulating Money Market Funds, ICA Release No. 18005, 56 Fed. Reg. 8113 (adopted Feb. 20, 1991) (the "1991 Amendments"); Technical Revisions to the Rules and Forms Regulating Money Market Funds, ICA Release No. 22921, 62 Fed. Reg. 64968 (Dec. 2, 1997) (revising amendments to Rule 2a-7 adopted in Revisions to Rules Regulating Money Market Funds, ICA Release No. 21837, 61 Fed. Reg. 13955 (Mar. 21, 1996) that never took effect) (the "1997 Amendments"); and Money Market Fund Reform, ICA Release No. 29132, 75 Fed. Reg. 10060 (adopted Feb. 23, 2010) (the "2010 Amendments").

[27] Report of the Money Market Working Group (Mar. 17, 2009), http://www.ici.org/pdf/ppr_09_mmwg.pdf.

[28] ICA Release No. 28807, *supra* Section 2, note 3.

4. Money Market Funds and the Financial Crisis

The dockets for the PWG Report and the FSOC Proposals[1] contain voluminous and conflicting accounts of the role played by MMFs in the recent financial crisis. We will not attempt to summarize or review these accounts, as the IM Division will need to provide such a summary before the Commission can propose further reforms. Instead, this section begins with the major findings and conclusions of the Financial Crisis Inquiry Commission (the "FCIC") regarding the global financial crisis. When viewed in the context of a protracted, worldwide crisis, it becomes apparent that the involvement of MMFs in the crisis was brief and limited, as documented by the Risk Fin Division's report on, among other questions, how MMFs performed during the financial crisis (the "Risk Fin Report")[2]. The section then returns to POF as an example of how prime MMFs responded during this brief period.

4.1 Factors Contributing to the Creation of the Financial Crisis

The FCIC conducted a full-scale examination of the financial crisis and the events leading up to it. While certain aspects of the FCIC's final report[3] have been criticized, it nevertheless helps to place the activities of MMFs during the financial crisis into perspective. It is particularly noteworthy that the FCIC never mentioned MMFs in their major findings and conclusions. This was not an oversight, insofar as none of their major conclusions (quoted in italics below) implicated MMFs.

> *We* [the FCIC] *conclude widespread failures in financial regulation and supervision proved devastating to the stability of the nation's financial markets.*[4]

The only reference to the Commission under this conclusion relates to its regulation of investment banks. Nowhere in its report did the FCIC suggest that the Commission failed to adequately regulate or supervise MMFs.

> *We conclude dramatic failures of corporate governance and risk management at many systemically important financial institutions were a key cause of this crisis.*[5]

"[L]arge investment banks and bank holding companies" were the "systemically important financial institutions" cited in this conclusion. Money market funds did not engage in activities identified in the conclusion, such as taking "on enormous exposures in acquiring and supporting subprime lenders and creating, packaging, repackaging, and selling trillions of dollars in mortgage-related securities, including synthetic financial products" or growing "aggressively through poorly executed acquisition and integration strategies."

> *We conclude a combination of excessive borrowing, risky investments, and lack of transparency put the financial system on a collision course with crisis.*[6]

Money market funds do not borrow and are restricted to investments presenting minimal credit risks. They are probably the most transparent investment current available to the public and certainly far more transparent than banks.

> *We conclude the government was ill prepared for the crisis, and its inconsistent response added to the uncertainty and panic in the financial markets.*[7]

The run by shareholders from prime MMFs to government securities, government MMFs and federally insured assets was a consequence of the uncertainty and panic caused by the regulators' inconsistent response. Investors had no idea which major institution would be the next to fail or how regulators would respond to it.

> *We conclude collapsing mortgage-lending standards and the mortgage securitization pipeline lit and spread the flame of contagion and crisis.*[8]

Rule 2a-7's maturity limits prevent MMFs from acquiring mortgages or mortgage-backed securities, so they were not part of the "securitization pipeline." Repurchase agreements for mortgage-backed securities provide the only tangential contact between MMFs and the mortgage market. The funds did not assume any of the credit or other risks of these securities from the seller in the repurchase agreement, and therefore did not contribute to the collapse in lending standards.

> *We conclude there was a systemic breakdown in accountability and ethics.*[9]

The ethical lapses discussed in this conclusion all related to the mortgage industry, in which MMFs do not participate.

> *We conclude over-the-counter derivatives contributed significantly to this crisis.*[10]

Money market funds do not engage in over-the-counter derivative transactions. Although vanilla interest rate and currency swaps secured some asset-backed commercial paper held by MMFs, these commercial paper programs generally did not involve the types of exotic derivatives discussed in this conclusion.

> *We conclude the failures of credit rating agencies were essential cogs in the wheel of financial destruction.*[11]

Rule 2a-7 requires MMFs to determine the minimal credit risk of portfolio securities "based on factors pertaining to credit quality in addition to any rating assigned to such securities." This means that MMFs could not blindly rely on ratings, which helped insulate them from "the failures of credit rating agencies." When the Commission's staff examined MMFs that held defaulted securities in 2007, they did not find that the manager's credit analysis lacked any material information or suggested any undue reliance on credit ratings.[12]

4.2 The Flight to Safety after the Lehman Brothers' Bankruptcy

The FCIC Report also documents a widespread concern for credit risk following the Lehman Brothers' bankruptcy and a general "run" by investors to the safety of government securities.

> "If you look at the firms that came under pressure in that period .... only one ... was not at serious risk of failure. ... So out of maybe the 13, 13 of the most important financial institutions in the United States, 12 were at risk of failure within a period of a week or two." *Federal Reserve Board Chairman Ben Bernanke, closed-door session with FCIC (Nov. 17, 2009).*[13]
>
> "You had people starting to take their deposits out of very, very strong banks, long way removed in distance and risk and business from the guys on Wall Street that were at the epicenter of the problem. And that is a good measure, classic measure of incipient panic." *Treasury Secretary Timothy Geithner, interview by FCIC (Nov. 17, 2009).*[14]
>
> "In the immediate wake of Lehman's failure on September 15, Morgan Stanley and similar institutions experienced a classic 'run on the bank,' as investors lost confidence in financial institutions and the entire investment banking business model came under siege." *John J. Mack, former CEO of Morgan Stanley, written testimony for the FCIC (Jan. 13, 2010).*[15]
>
> To protect themselves, hedge funds pulled billions of dollars in cash and other assets out of Morgan Stanley, Merrill, and Goldman in favor of prime brokers in bank holding companies .... Soon, hedge funds would suffer unprecedented runs by their own investors.[16]
>
> "The OTC derivatives markets came to a grinding halt, jeopardizing the viability of every participant regardless of their direct exposure to subprime mortgage-backed securities," *Michael Masters, hedge fund manager, testimony before the FCIC (June 30, 2010).*[17]
>
> In the eight days after Lehman's bankruptcy, depositors pulled $16.7 billion out of Washington Mutual, which now faced imminent collapse.[18]
>
> Wachovia lost $5.7 billion of deposits and $1.1 billion of commercial paper and repos that day [Friday, September 26, 2008]. By the end of the day on Friday, Wachovia told the Fed that wor-

ried creditors had asked it to repay roughly half of its long-term debt—$50 billion to $60 billion.[19]

There was, the FCIC found, "an extraordinary rush to the safest possible investments. Creditors and investors suspected that many other large financial institutions were on the edge of failure, and the Lehman bankruptcy seemed to prove that at least some of them would not have access to the federal government's safety net."[20]

4.3 Money Market Funds after the Lehman Brothers' Bankruptcy

MMF shareholders were not immune to this "extraordinary rush" following the Lehman Brothers' bankruptcy. This is reflected in Section 3 of the Risk Fin Report, which provides a synopsis of the significant events affecting MMFs during the period from September 2 through October 7, 2008, which the report terms the "Crisis Month." The Risk Fin Report begins, however, with defaults on certain "structured investment vehicles" or "SIVs" held by some prime MMFs in 2007.

> Beginning in August 2007, the market for commercial paper became relatively illiquid and commercial paper spreads widened by as much as 100 basis points. These issues, coupled with losses from investments related to mortgages, caused several structured investment vehicles (SIVs), including Cheyne Finance Plc and Axon Financial Funding LLC, which purchased longer-term assets by issuing commercial paper, to default. In the ensuing months, there were additional SIV defaults, and some assets held by money market funds were downgraded. Problems in the financial markets were compounded by the near collapse of Bear Stearns in March 2008 and the failure of auctions for auction-rate securities and the corresponding drop in liquidity.[21]

At a later point, the report cites a study by the staff of the Federal Reserve Bank of Boston finding that 11 prime MMFs received support from their sponsors for losses on SIVs that exceeded 0.5% of the funds' total assets.[22] To keep this finding in perspective, as of August 2007 there were 249 prime MMFs.[23]

The Risk Fin Report next focuses on major events during the Crisis Month.

> On September 7, 2008, the Federal Housing Finance Agency placed Fannie Mae and Freddie Mac in conservatorship. On September 14, 2008, Bank of America Corporation ("Bank of America") announced that it was buying Merrill Lynch & Co., Inc. ("Merrill Lynch"). The next day, September 15, 2008, Lehman Brothers filed for Chapter 11 bankruptcy protection, and on September 16, 2008 the Federal Reserve Bank's Board of Governors announced that the Federal Reserve Bank of New York

would financially support AIG. During this period, a number of securities issued by these firms and other financial institutions were downgraded.

> On September 16, 2008, The Reserve Primary Fund broke the buck, and several other money market funds would have broken the buck without sponsor support. The Reserve Primary Fund petitioned the SEC on September 22, 2008 to suspend redemptions. At this time, the fund began to unwind its positions and liquidate its portfolio in a process that took over a year to complete.[24]

More specifically, the Federal Reserve Bank of Boston study found that 13 prime MMFs might have broken a dollar during the period without sponsor support for their Lehman Brothers' holdings.[25]

The Risk Fin Report describes the run on prime funds during the week of Lehman Brothers' bankruptcy.

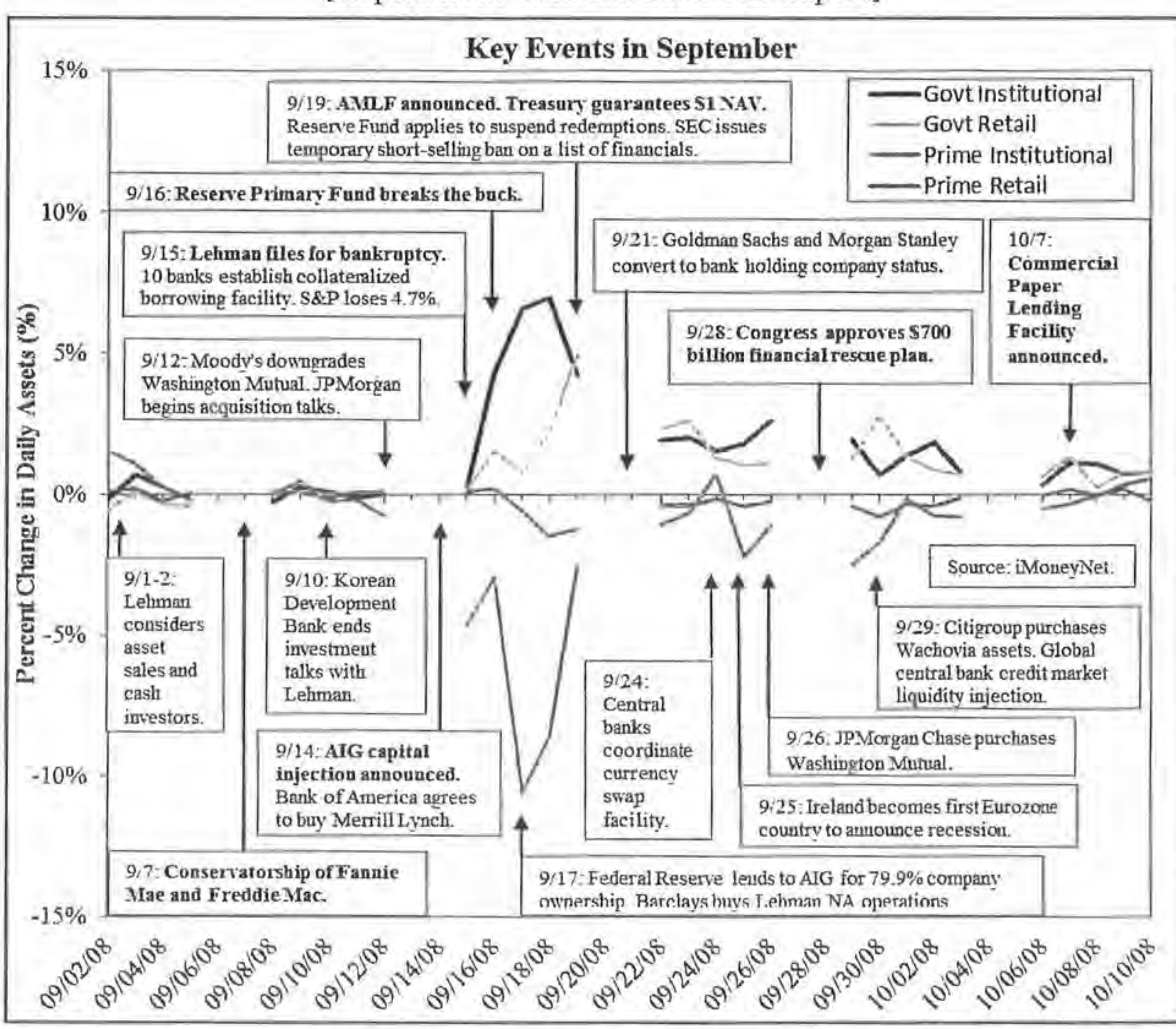
> Investors began selling prime money market funds on Friday, September 12th, ahead of Lehman Brothers' bankruptcy filing on Monday, September 15th. They continued to sell prime money market funds on Monday, September 15th. On the following day, The Reserve Primary Fund broke the buck, and the sell-off of prime funds continued. At the same time, investors began buying government money market funds, which include Treasury and government funds. During the Crisis Month (9/2/2008 to 10/7/2008), government money market fund assets increased by \$409 billion (44 percent), whereas prime fund assets fell by \$498 billion (24 percent).[26]

The Risk Fin Report also discusses the government's response to the run on prime MMFs, and relates these various events to changes in taxable fund assets over the period.

> On September 19, 2008, the U.S. Department of the Treasury announced the Temporary Guarantee Program for Money Market Funds [the "Temporary Guarantee Program"], which insured more than \$2.4 trillion in shares of money market funds, and the Federal Reserve Board authorized the Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility, which financed the purchases of high-quality asset-backed commercial paper from money market funds by U.S. depository institutions and bank holding companies. A number of other initiatives were undertaken by the Federal Reserve to stabilize both the underlying short-term credit market and money market funds in October 2008.
>
> Figure 5 [reproduced on the next page] graphs the change in daily assets of different types of MMFs by time and highlights the redemption activity surrounding the events of September 2008. (The chart is not continuous because many events

occurred over the weekend when MMFs did not trade.) There are two striking patterns in the net flow data. First, both institutional government and retail government funds received abnormally large daily net inflow during the calendar week of the crisis and, to a lesser extent, the following three calendar weeks. Institutional government funds received more net inflow than retail government funds during the first week, but the net inflow is similar in the following three weeks. The second change is the abnormally large daily net outflow in institutional prime funds and retail prime funds. In the calendar week of the crisis, institutional prime funds had large net outflow every day while retail prime funds had net outflow Wednesday through Friday only. Institutional prime funds continued with net outflow during the following two calendar weeks with the exception of one day. Retail prime funds also had net outflow during the following two calendar weeks, but their flow was much less than they experienced on Thursday and Friday of the crisis week.[27]

Figure 5
[Reproduced from the Risk Fin Report]



It should be emphasized that, although Figure 5 from the Risk Fin Report covers the entire Crisis Month, the outsized redemptions from prime MMFs were largely limited to the week immediately following the Lehman Brothers' bankruptcy. By the last week of the Crisis Month, net purchases and redemptions returned to the same levels experienced before the bankruptcy. This shows that MMFs were not affected until the financial crisis reached its peak following the Lehman Brothers' bankruptcy and were the first financial institutions to regain investor confidence during the crisis. In fact, prime MMF assets grew rapidly after the Crisis Month, reaching a high of $1.89 trillion in May 2009 as compared to $1.59 trillion at the end of September 2008.[28]

This growth in assets was not a product of the Temporary Guarantee Program, which only "provide[d] coverage to shareholders *for amounts that they held in participating money market funds as of the close of business on September 19, 2008*."[29] Thus, none of the money that came into MMFs after September 19 was guaranteed. It should also be noted: (1) the industry did not ask for the Temporary Guarantee Program, which was imposed unilaterally by Treasury Secretary Paulson;[30] (2) the guarantee was limited to $50 billion in the aggregate (just 2% of the $2.4 trillion held in covered MMFs);[31] (3) the Temporary Guarantee Program did not extend to the shareholders of the Reserve Primary Fund, who ultimately lost about one cent on the dollar; and (4) the Treasury earned $1.2 billion in premiums from the program, without any claims.[32]

The Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility ("AMLF"), on the other hand, was precisely the type of intervention expected of a central bank charged with maintaining market liquidity. The AMLF allowed MMFs to sell high quality, asset-backed commercial paper at its amortized cost to bank and broker-dealer subsidiaries of U.S. bank holding companies financed by loans from Federal Reserve Banks. The amount of the AMLF loan equaled the purchase price of the commercial paper and recourse for the loan was limited to the proceeds of the commercial paper (which the Federal Reserve Bank held as collateral).[33] The facility comprised less than 2% of the government's total emergency capital and liquidity support outstanding on a weighted-average monthly basis. A recent article by members of the Federal Reserve found that AMLF accounted for at least half of the decline in redemptions in the days immediately following its announcement, while presenting only minimal risks to the Federal Reserve Banks due to the high quality standards required by Rule 2a-7.[34]

Based on these facts, the Risk Fin Division concluded that:

> Although there are a number of possible explanations for investor redemptions in September 2008, *it is difficult, if not impossible, to attribute the redemptions to any single explanation*. [Emphasis added] That being said, there is a possibility that

> investor redemption behavior was attributable to the breaking of the buck by Reserve Fund and a "flight to quality" by risk averse investors. In addition, investor redemptions may have resulted from a flight by investors to funds offering liquidity, transparency, and performance. Finally, the influence on redemptions caused by the failure and, in some cases government-sponsored rescue, of prominent financial institutions ... [must be] considered.[35]

The staff also noted that, "although [earlier] events [involving defaults, insolvencies or other events adversely affecting money market securities shown in Table 1 of the Risk Fin Report] affected MMFs and their sponsors, the events did not appear to cause systemic problems."[36]

The Commission staff's conclusions are consistent with those of the European Commission:

> [I]n the context of the financial crisis, it must be noted that the underlying cause of risks to financial stability operating through money market funds did not originate in money markets. In particular, risks arose within the banking sector (due to securitised loan assets) that fed through to prime MMFs and due to the behaviour of investors in response to falling NAVs. [Europe has variable as well as stable NAV money market funds.] Moreover, the impact on MMF investors in terms of realised losses were either zero or very small.[37]

In summary, FCIC's findings and the Risk Fin Report clearly show: (1) MMFs did not contribute to the "bubble" in real estate financing that was the primary cause of the financial crisis; (2) the MMF industry handled, without any government assistance, the initial shocks from the collapse of the bubble that were transmitted to certain funds which held defaulted SIVs; (3) MMFs were not otherwise affected until the climax of the crisis following Lehman Brothers' bankruptcy; and (4) prime MMFs fully regained the confidence of investors only three weeks after Lehman Brothers' bankruptcy. Money market funds therefore played only a minor role in the greater scheme of the global financial crisis.

4.4 POF after the Lehman Brothers' Bankruptcy

Chart 1 in Subsection 1.1 above does not reflect the "run" on prime institutional MMFs in September 2008. The small downward spike just before huge run-up in assets at the end of 2008 represents a 6% decrease in assets from the end of August to the end of September 2008, with another 3% decrease in October.

Assets POF acquired from the Putnam Prime Money Market Fund (the "Putnam Prime Fund") during the course of the financial crisis in September mitigated this decrease. The Putnam Prime Fund held $17.4 billion on

September 12, 2008, but experienced a 30% decline in assets over September 15 and 16. On September 17, the fund's Board voted to close and liquidate the fund. This prudent and timely action prevented the Putnam Prime Fund from experiencing a run like the Reserve Primary Fund and allowed time to negotiate a solution with Federated to restore liquidity on terms that were fair to all shareholders.

On September 25, the Putnam Prime Fund exchanged $12.3 billion of assets in-kind for shares of POF. The Putnam Prime Fund immediately liquidated by distributing the POF shares to its shareholders. On that day, POF redeemed approximate 5 billion shares from former Putnam Prime Fund shareholders who had outstanding redemption orders, leaving POF with a net increase of approximately $7 billion in assets from the Putnam Prime Fund acquisition. POF utilized the AMLF to raise liquidity for these redemptions, selling $4.27 billion of asset-backed commercial paper through the AMLF on September 25 and 26.[38]

Without the Putnam Prime Fund acquisition, POF's assets would have decreased by $8.5 billion (33%) from the end of August to the end of September 2008. POF paid the redemptions primarily from its own resources, relying on the AMLF to sell only an addition $1.51 billion of asset-backed commercial paper from September 29 through October 1. POF nevertheless managed to maintain a higher degree of liquidity at the end of September than would have been required by the 2010 Amendments, with Daily Liquid Assets equal to 24% of total assets and Weekly Liquid Assets equal to 34% of total assets. All the commercial paper sold under the AMLF was repaid in full on its scheduled maturity date.

Chart 1 shows POF's assets more than doubling from $23.611 billion at the end of October 2008 to $53.210 billion at the end of August 2009. It should be emphasized that none of these additional assets were insured under the Temporary Guarantee Program, which applied only to share balances as of September 19, 2008 that were maintained in the *same* MMF. The strong flow of assets into POF reflects a general restoration of investor confidence in prime MMFs less than a month after the Reserve Primary Fund broke a dollar. Money market funds were the first major financial institutions to regain this confidence during the financial crisis.

---

[1] *Supra*, Section 2, note 1.

[2] Report of the Division of Risk, Strategy, and Financial Innovation, dated Nov. 30, 2012, Responding to Questions Posed by Commissioners Aguilar, Paredes and Gallagher Regarding Money Market Funds, http://www.sec.gov/news/studies/2012/money-market-funds-memo-2012.pdf.

[3] Financial Crisis Inquiry Commission, THE FINANCIAL CRISIS INQUIRY REPORT (2011) (the "FCIC Report"). An online version is available at http://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf.

[4] *Id.* at xviii.

[5] *Id.*

[6] *Id.* at xix.

[7] *Id.* at xxi.

[8] *Id.* at xxiii.

[9] *Id.* at xxii.

[10] *Id.* at xxiv.

[11] *Id.* at xxv.

[12] ICA Release No. 28807, *supra* Section 2, note 3, at 32699 n. 135.

[13] THE FINANCIAL CRISIS INQUIRY REPORT, *supra* note 3, at 354.

[14] *Id.* at 353-54.

[15] *Id.* at 353.

[16] *Id.* at 360-61.

[17] *Id.* at 363.

[18] *Id.* at 365.

[19] *Id.* at 367.

[20] *Id.* at 353.

[21] Risk Fin Report, *supra* note 2, at 6. Footnotes are omitted from the block quotations from the Risk Fin Report.

[22] *Id.* at 14 n.2, citing Steffanie A. Brady, Ken E. Anadu and Nathaniel R. Cooper, *The Stability of Prime Money Market Mutual Funds: Sponsor Support from 2007 to 2011,* Working Paper RPA 12-3 (Aug. 13, 2012), http://www.bostonfed.org/bankinfo/qau/wp/2012/qau1203.pdf, at Figure 4.

[23] Based on data from iMoneyNet Analyzer.

[24] Risk Fin Report, *supra* note 2, at 6-7.

[25] *The Stability of Prime Money Market Mutual Funds: Sponsor Support from 2007 to 2011, supra* note 2224, at Figure 4.

[26] *Id.* at 7.

[27] *Id.* at 12-13.

[28] Based on data from iMoneyNet Analyzer.

[29] Treasury Announces Temporary Guarantee Program for Money Market Funds (Sept. 29, 2009), http://www.treasury.gov/press-center/press-releases/Pages/hp1161.aspx [emphasis added].

[30] Henry M. Paulson, Jr. Comment Letter to the Commission (dated Feb. 22, 2012), http://www.sec.gov/comments/4-619/4619-183.pdf.

[31] Treasury Announces Temporary Guarantee Program for Money Market Funds, *supra* note 29.

[32] Audit of the Exchange Stabilization Fund's Fiscal Years 2009 and 2008 Financial Statements, http://www.treasury.gov/about/organizational-structure/ig/Documents/oig10027%20(ESF%20Financial%20Audit).pdf, at 26 (Dec.22, 2009).

[33] AMLF is described and analyzed in Burcu Duygan-Bump, Patrick Parkinson, Eric Rosengren, Gustavo A. Suarez, and Paul Willen, *How Effective Were the Federal Reserve Emergency Liquidity Facilities? Evidence from the Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility*, 68 J. FIN. 715 (2013).

[34] *Id.* The Federal Reserve also established the Commercial Paper Funding Facility ("CPFF") to assist issuers of commercial paper. The Federal Reserve Bank of New York made three-month loans to the CPFF, which used the loans to buy three-month commercial paper from issuers that could not obtain credit from the market. The CPFF, which was announced on October 7, 2008, provided relief to certain commercial paper issuers and to the banks whose liquidity facilities stood behind the commercial paper. The CPFF did not assist MMFs and was announced too late to account for the resurgence of assets into prime MMFs.

[35] Risk Fin Report, *supra* note 2, at 5.

[36] *Id.* at 15.

[37] European Commission Directorate-General for Economic and Financial Affairs, Economic Paper 472, *Non-bank Financial Institutions: Assessment of their Impact on the Stability of the Financial System* at 66 (Nov. 2012) [citation omitted].

[38] *See* http://www.federalreserve.gov/newsevents/files/amlf.xls for details of these transactions.

5. Current Regulation of Money Market Funds

Any reform proposal for MMFs must be evaluated against the backdrop of current regulations. Although books have been written about Rule 2a-7,[1] the following overview summarizes the most significant ways in which the rule and other Commission regulations already protect investors and the capital markets from any undue risks from MMFs.

5.1 Scope of Regulation

Any registered investment company must comply with the conditions of Rule 2a-7 before using the amortized cost or penny rounding method of valuing its redeemable securities.[2] In addition, any registered investment company holding itself out as a MMF or the equivalent of a MMF, or using the terms "money market" or other terms suggestive of a MMF in its name, must comply with the risk limiting conditions of Rule 2a-7.[3] Investment funds exempt from the ICA, such as hedge funds or other private investment funds and bank common or collective trust funds, do not have to comply with Rule 2a-7.

5.2 Disclosure to Shareholders

Money market funds must provide shareholders with a prospectus, periodic shareholder reports and, prior to shareholder meetings, proxy statements, in the same manner as other mutual funds. A MMF must include the following statement in the Risk/Return Summary of its prospectus:

> **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.**[4]

Any MMF advertisement must also include this statement.[5]

Unlike other mutual funds, MMFs must post on their website a complete listing of their portfolio as of the end of each month within five business days after such month-end.[6] They must also file an extensive monthly report with the Commission, which the Commission makes available to the public sixty days after the end of the month covered by the report.[7] Many funds voluntarily supplement these required disclosures. For example, Federated updates the portfolio information on its website twice a month and provides daily shadow prices for some of its prime MMFs, including POF.

5.3 Credit Risk

Rule 2a-7 retains the requirement of the original exemptive orders that the Board must determine that every portfolio security presents minimal credit risks.[8] The Board must consider factors in addition to a security's credit rating when making this determination. The Board may delegate this determination to the fund's officers or investment adviser, subject to the adoption of written procedures and periodic oversight by the Board.[9] POF's credit procedures were summarized in Section 1.1 above.

The 1991 Amendments transformed the exemptive orders' requirement of "high quality" into the definition of an "Eligible Security."[10] To qualify as an Eligible Security, the security must mature in 397 days[11] or less. If a security is rated (or of comparable priority and security to other rated securities of the same issuer or guarantor of the security), then the ratings must be in one of the two highest short-term rating categories.[12] If more than one nationally recognized statistical rating organization ("NRSRO") rates the security (or the comparable securities), then the fund uses the two highest ratings to determine eligibility.[13] Both ratings must be in one of the two highest short-term rating categories for the security to be eligible. Ratings subcategories and gradations are ignored for purposes of eligibility.

If both of the two highest ratings are in the highest short-term category (or if only one NRSRO has rated a security and the rating is in the highest category), the security is a First Tier Security;[14] all other Eligible Securities are Second Tier Securities.[15] A MMF cannot acquire Second Tier Securities in excess of 3% of its total assets. Second Tier Securities cannot have remaining maturities beyond 45 days. [16]

An unrated security also may be an Eligible Security if the Board determines that it is of comparable credit quality to rated Eligible Securities. The Board must also determine whether an unrated security is comparable to a First Tier or a Second Tier Security. Boards typically delegate these determinations to the fund's adviser.

A Demand Feature or a Guarantee may enhance the credit quality of a security. Generally, a Demand Feature is the right to demand repayment of a security at intervals of not more than 397 days with no more than 30 days' notice.[17] A Guarantee is an unconditional obligation of a party other than the issuer to pay principal and accrued interest on the security when due.[18] The definition of Eligible Security and other provisions of Rule 2a-7 impose additional requirements on securities subject to Demand Features and Guarantees to assure that funds rely on them in an appropriate manner.[19]

5.4 Diversification

Section 5(b) of the ICA[20] gives registered investment companies the option of being diversified or non-diversified companies. Section 5(b)(1) defines a "diversified company" as an investment company "meet[ing] the following requirements:"

> At least 75 per centum of the value of its total assets is represented by cash and cash items (including receivables), Government securities, securities of other investment companies, and other securities for the purposes of this calculation limited in respect of any one issuer to an amount not greater in value than 5 per centum of the value of the total assets of such management company ....

A Guarantee is not treated as a security issued by the guarantor unless more than 10% of the fund's total assets consist of securities either issued or guaranteed by the guarantor.[21]

Rule 2a-7 imposes more stringent diversification requirements on MMFs than Section 5(b). First, MMFs must be diversified companies.[22] Second, they generally must comply with the requirements of Section 5(b)(1) with respect to 100%, not just 75%, of their total assets.[23] Third, an issuer's Second Tier Securities must be less than 0.5% of a fund's total assets.[24] Fourth, the only other investment company securities permitted are shares of other MMFs operated in compliance with Rule 2a-7.[25]

Rule 2a-7 has separate diversification requirements for Demand Features and Guarantees. Generally, MMFs cannot acquire a security subject to a Demand Feature or Guarantee if it would result in investment of more than 10% of its total assets in securities issued by, and securities subject to Demand Features or Guarantees provided by, the guarantor or Demand Feature provider. Like Section 5(b)(1), these limitations apply to only 75% of a MMF's total assets.[26] This ability to exceed the 10% diversification limit with respect to Demand Features and Guarantees is referred to as the "25% basket." Funds may use the 25% basket to acquire only First Tier Securities subject to Guarantees or Demand Features provided by a company unaffiliated with the security's issuer.[27] Second Tier Demand Features and Guarantees from a single provider are limited to 2.5% of the fund's total assets.[28]

Securities guaranteed by a company unaffiliated with the issuer are limited only by the diversification requirements for the guarantor.[29] Rule 2a-7 has detailed provisions for the treatment of Asset Backed Securities, Repurchase Agreements Collateralized Fully by Government Securities, Conduit Securities and Refunded Securities[30] for purposes of diversification.

5.5 Interest Rate Risk

Normally, an obligation's market value changes inversely with changes in market interest rates, e.g., when interest rates go up, the obligation's value goes down. The less time remaining until maturity, however, the less a change in interest rates affects an obligation's value. This is because the holder of the obligation would not have to wait as long before it can reinvest the proceeds of the obligation in new obligations bearing interest at the current market rate. Thus, short-term obligations are less volatile than long-term obligations.

Rule 2a-7 imposes short maturity limits on MMFs in order to limit the risks associated with changing interest rates. We have already noted that the longest maturity permitted for a First Tier Security is 397 days and the longest for a Second Tier Security is 45 days. We also noted that the initial exemptive orders required a MMF to maintain a WAM "appropriate to its objective of maintaining a stable NAV per share" and not exceeding 120 days. Rule 2a-7 retains this requirement,[31] but shortened the maximum permitted WAM, first to 90 days in the 1991 Amendments and then to the current limit of 60 days in the 2010 Amendments. The Risk Fin Division found "the probability of breaking the buck for a MMF with a WAM of 60 days is close to zero,"[32] so compliance with Rule 2a-7 all but eliminates the risks caused by general movements in interest rates.

The inverse relationship between changes in interest rates and changes in market values will not pertain to an obligation that pays interest at a rate that is periodically adjusted to approximate current market rates. These obligations allow the holder to receive a current market rate without having to wait for the obligation to mature. Rule 2a-7 generally treats such obligations, termed "Floating Rate Securities" (if the interest rate is adjusted whenever there is a change in market rates) and "Variable Rate Securities" (if the interest rate is adjusted at fixed intervals),[33] as maturing on the date the interest rate is adjusted, provided the fund reasonably expects the obligation's market value to approximate its amortized cost after the adjustment.[34]

A Floating or Variable Rate Security must still have a remaining maturity, either by its terms or through exercise of a Demand Feature, of 397 days or less, unless it is a Government Security. Because interest rate adjustments may not always result in a security's market value approximating its amortized cost, Rule 2a-7 requires MMFs to recalculate their WAM based solely on their securities' stated maturities and Demand Features. This recalculated WAM is referred to as the weighted average life ("WAL") or the adjusted WAM. A fund's adjusted WAM cannot exceed 120 days.[35] This 120-day limit protects a fund from declines in market value due to a revaluation of credit or other risks by the market that is not reflected in the adjustments.

5.6 Liquidity

After maintaining a stable NAV, daily liquidity is the next most important objective of a MMF. Although the Commission addressed the Board's responsibility for overseeing a fund's liquidity in the release adopting Rule 2a-7 and in subsequent releases, Rule 2a-7 did not include any specific liquidity requirements until the 2010 Amendments.

The first requirement added in 2010 codified the "Know-Your-Customer" procedures commonly employed by fund managers. Technically, Rule 2a-7 requires a MMF to "hold securities that are sufficiently liquid to meet reasonably foreseeable shareholder redemptions ... and any commitments the fund has made to shareholders."[36] A manager cannot "reasonably foresee" redemptions without knowing the potential liquidity demands of its shareholders. Hence, this provision forms the basis for requiring a "Know-Your-Customer" process for MMFs, just as the minimal credit risk determination forms the basis for requiring a credit review and approval process. POF's "Know-Your-Customer" processes were summarized in Section 1.1 above.

The second added requirement set floors for Daily Liquid Assets (10% of total assets) and Weekly Liquid Assets (30% of total assets).[37] With important exceptions discussed in the next paragraph, the floors assure that MMFs have the capacity to raise liquidity in one business day (in the case of Daily Liquid Assets) or five business days (in the case of Weekly Liquid Assets) without selling securities. This allows a MMF to absorb redemptions of at least 10% of its shares in a single day, or 30% in any one-week period, without the risk of realizing losses.[38] Thus, Daily Liquid Assets must come due on the next business day or be payable within one day after demand for payment and Weekly Liquid Assets must come due within five days or be payable on demand without more than five business days' notice.

There is an exception to the "liquidity without sale" concept for U.S. Treasury securities (which qualify as Daily Liquid Assets) [39] and federal agency discount notes with remaining maturities of 60-days or less (which qualify as Weekly Liquid Assets). [40] The exception is based on the historical liquidity of the secondary market for these securities. Even during the height of the financial crisis in 2008, the markets for these securities remained liquid. Moreover, during a flight to safety in the market, these securities tend to trade at premiums to their amortized cost.[41]

Finally, the Commission amended Rule 2a-7 to codify long-standing guidance limiting the amount of Illiquid Securities a MMF may acquire. A security is "illiquid" if it cannot be disposed of for approximately its shadow price within seven calendar days.[42] The 2010 Amendments reduced the limit on Illiquid Securities from 10% to 5% of a fund's total assets.[43]

5.7 Currency Risk

Money market funds may invest only in securities that are denominated in U.S. dollars. Moreover, the payment terms of Eligible Securities cannot "vary or float with the value of a foreign currency, the rate of interest payable on foreign currency borrowings, or with any other interest rate or index expressed in a currency other than United States dollars."[44] This prevents changes in foreign exchange rates from affecting a fund's stable NAV.

5.8 Board Oversight

The original exemptive orders stated that establishment of procedures to stabilize a MMF's NAV was "a particular responsibility within the overall duty of care owed [by a Board] to its shareholders." Rule 2a-7 still uses these words to define the Board's overall responsibilities.[45] The rule also continues to require the Board to monitor the deviation between a fund's shadow price and its stable NAV, and to "cause the fund to take such action as it deems appropriate to eliminate or reduce to the extent reasonably practicable [excessive] dilution or unfair results" produced by the deviation.[46] The Board also must still consider what action, if any, should be taken if the deviation exceeds half a cent per share.[47]

Rule 2a-7 requires a MMF to dispose of a portfolio security following a default or similar event that might threaten the fund's stable NAV, "absent a finding by the board of directors that disposal of the portfolio security would not be in the best interests of the MMF (which determination may take into account, among other factors, market conditions that could affect the orderly disposition of the portfolio security)."[48] By giving the Board discretion to hold onto an impaired security until market conditions improve, Rule 2a-7 avoids forcing funds to engage in a "fire sale" that might disrupt capital markets. Even if the fund disposes of the security, Rule 2a-7 requires the Board promptly to review "the adviser's actions in the event of the default of a security or Event of Insolvency ... to assure that [its] guidelines and procedures are being followed."[49]

A MMF may "continue to use [the Amortized Cost or Penny Rounding M]ethod only so long as the board of directors believes that it fairly reflects the market-based net asset value per share."[50] If, as a result of one or more of the foregoing events or for any other reasons, the Board no longer believes this to be the case or determines that continuing to maintain a stable NAV would not be in the interest of the fund's shareholders, the fund can no longer rely on Rule 2a-7 and must calculate its share price in compliance with ASR 219. This is known as "breaking a dollar." Every MMF must have the capacity to calculate a share price on this basis.[51]

Other provisions of the ICA and regulations thereunder give a Board alternatives to breaking a dollar. First, Section 22(e) of the ICA[52] permits any mutual fund to delay the payment of redemption proceeds for a period not to exceed seven days. Second, the ICA's definition of "redeemable security"[53] contemplates that a redeeming shareholder may "receive approximately his proportionate share of the issuer's current net assets" in lieu of "the cash equivalent thereof." Delivery of a share of portfolio securities in exchange for redeemed shares is known as "redemption in-kind." Rule 18f-1 allows a fund to file an irrevocable election "committing itself to pay in cash all requests for redemption by any shareholder of record, limited in amount with respect to each shareholder during any ninety-day period to the lesser of (i) $250,000, or (ii) 1% of the net asset value of such company at the beginning of such period."[54] This allows a fund to redeem both in-kind and in-cash without violating limitations on the issuance of senior securities.

Third, Rule 17a-9[55] allows an "affiliated person"[56] to purchase portfolio securities from a MMF for the greater of their amortized cost or current market value. Rule 17a-9 permits a MMF's manager or an affiliated person of the manager to provide support to the fund by purchasing securities that the fund cannot sell in the market for their amortized cost. Section 17(a) of the ICA[57] would prohibit such transactions in the absence of the exemption provided by Rule 17a-9.

Finally, Rule 22e-3,[58] adopted as part of the 2010 Amendments, permits a Board to suspend redemptions entirely after adopting an irrevocable plan of liquidation for its MMF. This gives the Board the means to check any run by the fund's shareholders and consequent sale of the portfolio at potentially distressed prices.* The maturity limits of Rule 2a-7 assure that the fund will quickly recover the amortized cost value of any portfolio securities (except defaulted securities) that it cannot sell. If the fund complied with the Weekly Liquid Asset limit at the time of liquidation, shareholders would receive at least 30% of their investment in the first week of the liquidation. Compliance with the WAM limitation should assure the return of a majority of each shareholder's investment within 60 days of the commencement of the fund's liquidation. If the fund has the opportunity to dispose of portfolio securities, this would speed up the shareholders' recovery.

Rule 2a-7 also prescribes specific oversight responsibilities for the Board. For example, the Board must adopt procedures for periodic stress testing of the fund and monitor the stress testing results.[59] The Board must

* Section 22(e) of the ICA, 15 U.S.C. § 80a-22(e), prohibits a mutual fund from suspending redemptions except:

> (1) for any period (A) during which the New York Stock Exchange is closed other than customary week-end and holiday closings or (B) during which trading on the New York Stock Exchange is restricted;
>
> (2) for any period during which an emergency exists as a result of which (A) disposal by the company of securities owned by it is not reasonably practicable or (B) it is not reasonably practicable for such company fairly to determine the value of its net assets; or
>
> (3) for such other periods as the Commission may by order permit for the protection of security holders of the company.

Section 22(e) further authorizes the Commission "by rules and regulations [to] determine the conditions under which (i) trading shall be deemed to be restricted and (ii) an emergency shall be deemed to exist …." Thus, in the absence of Rule 22e-3, a MMF needing to suspend redemptions would have to apply to the Commission for an order under § 22(e)(3).

also adopt written guidelines and procedures for any Board responsibilities delegated to the fund's officers or to its investment adviser, and must "take any measures reasonably necessary ... to assure that the guidelines and procedures are being followed."[60] Such measures must include "periodic reviews of fund investments and the delegate's procedures in connection with investment decisions." Finally, the Board is responsible for adopting and periodically reviewing specific compliance and recordkeeping procedures.[61]

---

[1] Stephen Keen, RULE 2A-7 IN CONTEXT: THE APPLICATION OF RULE 2A-7 TO VARIOUS MONEY MARKET INSTRUMENTS (Outline for Crane's Money Fund University 2013); Joan Ohlbaum Swirsky, THE GUIDE TO RULE 2A-7: A MAP THROUGH THE MAZE FOR THE MONEY MARKET PROFESSIONAL (2d ed. 2011).

[2] 17 C.F.R. § 270.2a-7(c).

[3] 17 C.F.R. § 270.2a-7(b).

[4] Form N-1A, 17 C.F.R. § 274.11a, Item 4(b)(1)(ii).

[5] 17 C.F.R. § 230.482(b)(4).

[6] 17 C.F.R. § 270.2a-7(c)(12).

[7] 17 C.F.R. § 270.31b-7.

[8] 17 C.F.R. § 270.2a-7(c)(3)(i).

[9] 17 C.F.R. § 270.2a-7(e).

[10] 17 C.F.R. § 270.2a-7(a)(12).

[11] Three-hundred ninety-seven is the number of days in a period of thirteen months that includes a leap day.

[12] DFA § 939A(b), 15 U.S.C. § 78o-7, requires the Commission (and other federal agencies) "to remove any reference to or requirement of reliance on credit ratings and to substitute in such regulations such standard of credit-worthiness as each respective agency shall determine as appropriate for such regulations ...." The Commission has proposed to remove references to NRSROs and credit ratings from Rule 2a-7, References to Credit Ratings in Certain Investment Company Act Rules and Forms, ICA Release No. 29592, 76 Fed. Reg. 12896 (proposed Mar. 3, 2011), but has not taken final action on the proposal. In the interim, the Division has suspended provisions added in the 2010 Amendments requiring the Board to designate and monitor NRSROs. Investment Co. Inst., SEC No-Action Letter (Aug. 19, 2010), http://www.sec.gov/divisions/investment/noaction/2010/ici-nrsro081910.htm.

[13] 17 C.F.R. § 270.2a-7(a)(29) (defining the "Requisite NRSROs").

[14] 17 C.F.R. § 270.2a-7(a)(14).

[15] 17 C.F.R. § 270.2a-7(a)(24).

[16] 17 C.F.R. § 270.2a-7(c)(3)(ii).

[17] 17 C.F.R. § 270.2a-7(a)(9).

[18] 17 C.F.R. § 270.2a-7(a)(17). *See, also,* the definition of an "Unconditional Demand Feature," 17 C.F.R. § 270.2a-7(a)(29).

[19] *E.g.*, 17 C.F.R. § 270.2a-7(a)(12)(iii) (requiring notification of any substitution of a Guarantee or Demand Feature), (c)(3)(iv) (requiring minimal risk of the termination of a

Conditional Demand Feature), and (c)(10)(i) (requiring continual review of the minimal credit risk of a security subject to a Demand Feature).

[20] 15 U.S.C. § 80a-5(b).

[21] 17 C.F.R. § 270.5b-2(a).

[22] 17 C.F.R. § 270.2a-7(c)(4).

[23] 17 C.F.R. § 270.2a-7(c)(4)(i). To allow for unanticipated inflows of cash, MMFs are permitted to use up to 25% of their total assets to acquire securities of a single issuer, provided that the issuer's securities are then reduced to 5% of total assets within three business days. Due to supply limitations, tax-exempt funds that limit their investment to a single state may acquire First Tier Securities in excess of the 5% limit, providing they do not exceed, in the aggregate, 25% of the fund's total assets.

[24] 17 C.F.R. § 270.2a-7(c)(4)(i)(C).

[25] 17 C.F.R. § 270.2a-7(c)(4)(ii)(E).

[26] 17 C.F.R. § 270.2a-7(c)(4)(iii).

[27] 17 C.F.R. § 270.2a-7(c)(4)(iii)(C).

[28] 17 C.F.R. § 270.2a-7(c)(4)(iii)(B).

[29] 17 C.F.R. § 270.2a-7(c)(4)(i).

[30] Respectively defined in 17 C.F.R. § 270.2a-7(a)(3), (a)(5), (a)(7) and (a)(22) and addressed in (c)(4)(ii).

[31] § 270.2a-7(c)(2)(ii).

[32] Risk Fin Report, *supra* Section 4, note 2, at 30.

[33] Respectively defined in 17 C.F.R. § 270.2a-7(a)(15) and (a)(31).

[34] 17 C.F.R. § 270.2a-7(d)(2)-(5). In rare cases, a Floating or Variable Rate Security's maturity will be determined by reference to a Demand Feature, if the period required to exercise the Demand Feature is shorter (in the case of securities with a remaining stated maturities of 397 days or less) or longer (in the case of securities with longer remaining stated maturities) than the period until the next interest rate adjustment.

[35] § 270.2a-7(c)(2)(iii).

[36] § 270.2a-7(c)(5).

[37] Respectively defined in 17 C.F.R. § 270.2a-7(a)(8) and (a)(32).

[38] 17 C.F.R. § 270.2a-7(c)(5)(ii)-(iii).

[39] 17 C.F.R. § 270.2a-7(a)(8)(ii).

[40] 17 C.F.R. § 270.2a-7(a)(32)(iii).

[41] 2010 Amendments, *supra* Section 3, note 26, at 10078-9.

[42] 17 C.F.R. § 270.2a-7(a)(19).

[43] 17 C.F.R. § 270.2a-7(c)(5)(i).

[44] 17 C.F.R. § 270.2a-7(a)(29).

[45] 17 C.F.R. § 270.2a-7(c)(8)(i) and (c)(9).

[46] 17 C.F.R. § 270.2a-7(c)(8)(ii)(C).

[47] 17 C.F.R. § 270.2a-7(c)(8)(ii)(B).

[48] 17 C.F.R. § 270.2a-7(c)(7)(ii). In addition to an event of default, a MMF is required, absent a contrary finding by the Board, to dispose of a security that no longer qualifies as an Eligible Security, is no longer determined to present minimal credit risks or is affected by an Event of Insolvency (as defined in 17 C.F.R. § 270.5b-3(c)(2)). The fund also must notify the Commission of an event of default or insolvency affecting securities representing 0.5% or more of the fund's total assets. 17 C.F.R. § 270.2a-7(c)(7)(iii)(A).

[49] 17 C.F.R. § 270.2a-7(e)(2).

[50] 17 C.F.R. § 270.2a-7(c)(1).

[51] 17 C.F.R. § 270.2a-7(c)(13).

[52] 15 U.S.C. § 80a-22(e).

[53] *Supra* Section 3, note 2.

[54] 17 C.F.R. § 270.18f-1.

[55] 17 C.F.R. § 270.17a-9. This rule was adopted as part of the 1997 Amendments and expanded by the 2010 Amendments. A fund must notify the Commission of any transactions under Rule 17a-9. 17 C.F.R. § 270.2a-7(c)(7)(iii)(B).

[56] Defined in 15 U.S.C. § 80a-2(a)(3) to include, among other persons, a fund's investment adviser.

[57] 15 U.S.C. § 80a-17(a). This section prohibits, among other transactions, an affiliated person of an investment company (or an affiliated person of such an affiliated person) from acquiring assets from the investment company.

[58] 17 C.F.R. § 270.22e-3.

[59] 17 C.F.R. § 270.2a-7(c)(10)(v).

[60] 17 C.F.R. § 270.2a-7(e).

[61] 17 C.F.R. § 270.2a-7(c)(10)-(11).

6. Conclusions

With the orientation provided by the preceding sections, we can now examine the questions raised in the Executive Summary.

(a) Would any of the FSOC Proposals have prevented the flight to safety that occurred from virtually all asset classes in September 2008?

No. As shown in Section 4 above, the FCIC concluded that factors having nothing to do with MMFs generated suspicions as to the impending failure of large financial institutions and the ensuing "rush to the safest possible investments" (i.e., U.S. Treasury and agency securities). As MMFs did not cause this flight to safety, imposing new restrictions on MMFs could not have prevented it. Even assuming that investors found a way to use a floating NAV fund for cash management, they would still have had a strong motivation to redeem out of concern that any of the issuers held in their funds might have been the next Lehman Brothers. Their motivation to redeem would probably have been more powerful if redemptions started a 30-day clock running before they could recover the full balance of their account. Finally, shareholders conditioned to rely on capital, rather than the quality of the fund's portfolio and management, would have been likely to redeem as soon the capital was impaired by defaults or declines in the market value of the portfolio.

(b) Would any of the FSOC Proposals have prevented the freeze-up in the short-term credit markets that took place during the depths of the financial crisis?

No. The freeze-up in the credit markets, like the redemptions from prime MMFs, was a product of the general concern regarding the continued viability of large financial institutions and the corresponding lack of liquidity in the market. No one was willing to extend credit to an institution that might be "the next Lehman" or to buy such an institution's outstanding obligation. Secretary Geithner admitted to the FCIC that there was "a *broad-based* run on commercial paper markets."[1] The freeze-up was not simply a consequence of redemptions from the prime MMFs.

The FSOC Proposals would have done nothing to ameliorate the freeze-up. None of the proposed reforms would have prevented shareholders from redeeming from prime MMFs to avoid exposure to shaky financial institutions. The need to sell portfolio securities to fund these redemptions would have added to concerns about liquidity, increasing the unwillingness of other investors to buy short-term obligations. The Daily/Weekly Liquid Asset floors already adopted by the Commission would have been much more effective in assuaging investors' concerns about liquidity than any of the FSOC Proposals.

(c) If money market funds had not existed in 2008, is there any reason to believe the seizing up of the commercial paper market and short-term credit markets more broadly would not have occurred?

No. If MMFs had not existed, there are reasons to believe that the seizing up of the short-term credit markets would have been more severe and protracted. According to the FSOC Proposals, "in the three weeks following the Lehman bankruptcy, prime MMFs reduced their holdings of CP by $202 billion (29 percent) and repo by $75 billion (32 percent)."[2] During this three-week period, however, prime MMFs lost $429 billion in assets.[3] This shows that prime MMFs reduced their holdings of commercial paper and repurchase agreements during the financial crisis wholly in response to shareholder redemptions. MMF shareholders, not MMF managers, joined the "extraordinary rush to the safest possible investments." The ability of prime MMFs to absorb the remaining $152 billion of redemptions without reducing commercial paper or repurchase agreements actually cushioned the impact of this flight to safety on the short-term credit markets.

Prime MMFs also limited the period during which the short-term credit markets were disrupted by the financial crisis. It is unlikely that institutional investors would have regained confidence in direct, undiversified holdings of commercial paper as quickly as they regained their confidence in prime MMFs. Once the Federal Reserve stepped in to assure liquidity through the AMLF, by the second week of October cash began flowing back into prime MMFs and they resumed funding commercial paper. It is uncertain that the Federal Reserve could have implemented a facility like the AMLF without MMFs, given the much larger number of institutional investors that would have been involved and uncertainty as to whether their holdings presented minimal credit risks. Even if the Federal Reserve could have implemented such a facility, it probably would not have had such an immediate effect on investor confidence.

(d) Would any of the FSOC Proposals prevent a "run" from money market funds or the short-term credit markets in a future financial crisis?

No. The Council concedes that each of its proposed alternatives would fail to prevent a run on MMFs during periods of financial stress or uncertainty. Specifically:

> [The Floating NAV Proposal] would not remove a shareholder's incentive to redeem whenever the shareholder believes that the NAV will decline significantly in the future ....[4]

> [The Minimum Balance at Risk Proposal] likely would not be sufficient to stop a run on an MMF if investors anticipate very large losses [or stop a run on other funds if] investors expect that large losses would be incurred across MMFs.[5]

> [The Capital Proposal is] unlikely to be large enough to absorb all possible losses and may not be sufficient to prevent investors from redeeming when they expect possible losses in excess of the NAV buffer.[6]

In other words, the FSOC Proposals will only prevent runs on MMFs by preventing investors from using MMFs to begin with. As Section 2 above demonstrated, this will be the unavoidable result of the Commission's adoption of any of these proposed reforms.

(e) If, as a result of regulatory restrictions, money market funds do not exist going forward, or if their assets under management are substantially reduced, where will those assets move, and will there be a consequent reduction or increase in systemic risk in the financial markets?

Cash will move out of MMFs and into other stable value alternatives, which will increase systemic risk. Both the Risk Fin Report and the FSOC Proposals were too tentative in their analysis of this issue. Table 6 of the Risk Fin Report lists possible alternatives to MMFs and observes, "money market fund investors would have to analyze the various tradeoffs associated with a shift to one of the available cash investment alternatives."[7] Although the Risk Fin Report discusses the trade-offs in some depth, it does not draw any conclusions as to how much cash would be shifted. The FSOC Proposals did not include any analysis on this point, merely acknowledging:

> Expected benefits could be diminished if investors switched to alternative cash-management vehicles because MMFs become less attractive. If those cash-management vehicles are themselves vulnerable to runs and are also interconnected with other parts of the financial system, the benefits to long-term economic growth that result from mitigating the probability and severity of financial crises could be reduced.[8]

Section 2 above showed how any of the FSOC Proposals will drive investors out of MMFs, because no one has proposed any solutions to the inherent problems of using a floating NAV fund for cash management, no intermediaries would support and no investors would accept the complex and onerous restrictions of the Minimum Balance at Risk Proposal, and no one can afford the Capital Proposal. Thus, it is certain that adoption of the FSOC Proposals would lead to most of the cash currently held in MMFs "switch[ing] to alternative cash-management vehicles."

The need for a stable value in cash management explained in Subsection 1.4 above will determine which alternatives investors use for their cash. Bank demand deposits, short-term investment funds ("STIFs"), local government investment pools ("LGIPs") and private enhanced cash funds (including offshore MMFs) are the only stable value cash investment alternatives shown in Table 6 of the Risk Fin Report. It follows that investors will shift their cash primarily to these alternatives. Given that "[o]ne practical constraint is that some investors may not have access to LGIPs, STIFs or offshore MMFs due to the significant restrictions on who is eligible to participate,"[9] it should also be clear that big banks would be the principal recipients of this cash. Figure 18 of the Risk Fin Report confirms this intuition, showing a nearly dollar-for-dollar shift in cash held by non-financial business from MMFs to checkable bank deposits from 2008 to 2011.

"Too-big-to-fail" banks are a primary source of systemic risk to the financial system. It has been estimated that a majority of MMF assets are held in funds sponsored by a bank holding company designated as systemically important under the DFA.[10] No one can reasonably claim that proposals that would cause investors to shift over a trillion dollars from prime MMFs (and another trillion dollars from government MMFs in the case of the Floating NAV or Minimum Balance at Risk Proposals) to already "too-big-to-fail" banks would ameliorate systemic risks in the financial system.

Shifting cash to bank deposits will also deprive investors of the opportunity to earn a market rate of return on their cash. Retail investors, and even most institutional investors, cannot directly access the money markets. This was a major reason for the initial popularity of MMFs in the late 1970s and early 1980s, a highly inflationary period when banks offered low rates for deposits. MMFs allowed investors, small and large, to protect their savings by earning returns more commensurate with the rate of inflation. Chart 3 in Subsection 1.3 above showed the historically low rates of interest offered by banks when faced with competition from MMFs. These rates would be even lower in the absence of this competition, leaving investors without any means of protecting their savings from inflation.

Shifting cash held by qualified institutional investors to STIFs, LGIPs and private enhance cash funds will also fail to mitigate systemic risk. All three of these alternatives existed at the outset of the financial crisis. Whereas *one* MMF broke a dollar and suffered a run at the height of the financial crisis in September 2008 (but ultimately returned 99 cents a share to its shareholders), *several* LGIPs and private enhanced cash funds broke a dollar and suffered runs in the last quarter of *2007*.[11] The Florida LGIP, for example, suspended redemptions and placed 14% of its portfolio in a restricted fund for impaired investments. Banks also provided support to STIFs that held SIVs and Lehman Brothers commercial paper or notes.[12] One bank continued to transact in STIFs at a constant $1 value, even though the underlying shadow price was less than 91 cents—something Rule 2a-7 would not have permitted.[13] Each of these alternatives is less regulated and transparent, and proved less resilient during the financial crisis, than MMFs. Reforms that drive institutional investors from MMFs to these alternatives would increase systemic risks in the financial system.