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WORLD-CLASS INVESTMENT MANAGER ®

January 7, 2013

Mr. Craig Lewis, Director
Division of Risk, Strategy, and Financial Innovation
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549-1090

Re: Response to Questions Posed by Commissioners Aguilar, Paredes and Gallagher

Dear Mr. Lewis:

We are writing to comment on the report of the Division of Risk, Strategy, and Financial Innovation (the "Division"), dated November 30, 2012, responding to questions posed by Commissioners Aguilar, Paredes and Gallagher regarding money market funds (the "Report").[1] As you are aware, Federated Investors, Inc. ("Federated") is one of the oldest and largest managers of money market mutual funds ("MMFs") in the United States.[2] We hope that our experience will help add context to some of the findings in the Report and will assist the Division in refining its research into these matters.

Although we do not fully agree with some important aspects of the Report, Federated would nevertheless like to congratulate the Division for providing an in-depth response to these complex questions within a period of only ten weeks. The Report's analysis is more balanced than any federally sponsored study of MMFs since the President's Working Group on Financial Markets' study of possible money market fund reforms (the "PWG Report").[3] The Division has served the Commission and the public well by sharing the information underlying its analysis, and by acknowledging the limitations of the information and the conclusions drawn therefrom. This provides a foundation for a constructive dialogue in which the MMF industry can provide more extensive and refined data for the Division to analyze and openly debate what conclusions may be reasonably drawn from the data. Federated hopes the Division and the Commission will regard this letter as another step in that dialogue.

[1] The Report is available at http://www.sec.gov/news/studies/2012/money-market-funds-memo-2012.pdf.

[2] Federated is one of the largest investment management firms in the United States, managing $364.1 billion in total assets as of September 30, 2012. As of November 30, 2012, Federated was the second largest manager of U.S. registered money market funds, managing $238.5 billion in total assets. Federated launched its first money market fund in 1974.

[3] The PWG Report was published for comment in Release No. IC-29497, President's Working Group Report on Money Market Funds (Nov. 3, 2010), available at http://www.sec.gov/rules/other/2010/ic-29497.pdf. As the Report was linked to the site for comments on the PWG Report, Federated will file a copy of this letter at that site as well.

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I. MATTERS CONFIRMED BY THE REPORT

Before commenting on areas in the Report that could benefit from further research and analysis, we begin by acknowledging important conclusions drawn in the Report, whether expressly stated or clearly implied by the Division's analysis. These conclusions confirm points made in the numerous comment letters filed in response to the PWG Report and to various reform proposals generated by the PWG Report. If both sides of the reform debate accept these as settled questions, they will provide a framework for establishing the objectives of any further reforms and evaluating whether proposed reforms would accomplish those objectives.

A. Significant Findings of the Report

1. Since 1994, 95% of MMFs Have Almost Continuously Maintained Shadow Prices of at Least $0.999.

Figure 16 shows "Shadow NAV Distributions Since 1994."[4] Except for two brief periods, Figure 16 shows 95% of MMFs continuously maintained market-based net asset values per share ("shadow NAVs") of $0.999 or greater. The two exceptions are the first half of 1994, when the Federal Reserve unexpectedly implemented a series of significant interest rate hikes, and the height of the financial crisis in September 2008. Neither of these events caused the shadow NAVs of these funds to fall below $0.998.

Figure 16 demonstrates that rule 2a-7 has succeeded in assuring that a stable $1 price "fairly reflects the market-based net asset value per share" of MMFs. There is no reason to expect a MMF's shadow price to deviate significantly from a dollar due to market fluctuations (as distinguished from credit events like those shown in Table 1 of the Report). This is why there is rarely any so-called "first mover advantage" for MMF shareholders.[5] MMF Boards can prevent any such advantage from arising by suspending redemptions or breaking a dollar immediately upon the occurrence of an event that threatens their fund's stable value.

2. Few Prime MMFs Experience Weekly Redemptions of More Than 10%, and, Except for the Peak of the Financial Crisis, Weekly Redemptions Have Never Approached 15% for a Significant Number of Prime MMFs

Figure 1 of the Report shows the "Weekly Investor Redemption Distribution Since 2004" for prime MMFs. At no point during this period did the mean redemptions from prime MMFs

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[4] Shadow NAVs are "calculated using available market quotations (or an appropriate substitute that reflects current market conditions)." Rule 2a-7(c)(8)(ii)(A)(*1*). Actual trading prices inevitably differ from such quotations (or substitutes for quotations), and may be closer to the amortized cost of the security. Figure 16 is based on information provide in Form N-SAR, and is therefore subject to our comments in Section II.B below.

[5] It was appropriate for the Report to use a relatively large loss (for a MMF) of 40 basis points to illustrate the incentive that a realized loss may create for shareholders to redeem shares. This contrasts with the Financial Stability Oversight Council's claim that "even small portfolio losses" could create a "first-mover advantage." Proposed Recommendations Regarding Money Market Mutual Fund Reform, Docket No. FSOC-2012-0003, 77 Fed. Reg. 69455, 69460 (Nov. 19, 2012). The Report provides no example of a small loss having such an effect.

approach 10%. In fact, even during the height of the financial crisis (the week following Lehman's bankruptcy), mean redemptions only slightly exceeded 5%.

Figure 1 also shows 14 weeks during which 5% of prime MMFs[6] experienced net redemptions exceeding 10%. As Figure 1 covers a period of over eight years, this represents approximately 3% of the weeks during the period. It should be noted that half of these weeks occurred during the financial crisis. If the Division extended its study to earlier periods, we expect the results would be consistent with the period from 2004 through 2006, with 5% of the Prime MMFs experiencing redemptions of more 10% only twice during this period.

We do not mean to imply that redemptions in excess of 10% in a week are a cause for concern. Large shareholders may redeem shares to pay for a major transaction or to transfer their cash to an alternative investment. When combined with normal shareholder activity, such large redemptions may push net redemptions above 10% in a given week. Appropriate "know your customer" procedures will alert a portfolio manager to such redemptions and permit the manager to cover the redemption without depleting the MMF's daily or weekly liquid assets. The ability of nearly all funds to maintain stable daily and weekly liquid assets, as shown in Figure 7 of the Report, even during the spikes in redemptions during the summer of 2011 shown in Figure 1, illustrates this point.

We realize the Report states (at p. 36) that, "According to Figure 1, it is not unusual for weekly net redemptions to exceed 10 percent." Although we would not characterize something that occurs only 3% of the time as "not unusual," no one should dispute the relevance of Figure 1 to the impact of the 2010 reforms. As a result of these reforms, MMFs maintain weekly liquid assets of more than triple the amount of weekly redemptions that funds have experienced during normal market conditions and of more than twice the amount of redemptions that funds have experienced in all but the most dire market conditions.

3. *"Under the assumptions in the model, the probability of breaking the buck for a money market fund with a WAM of 60 days is close to zero" (Report at 30), but "consider that the losses incurred by The Reserve Primary Fund would still have been realized had the 2010 amendments been in place in September 2008." (Report at 36)*

We link these two statements because we never want to give the impression that the risk of any MMF breaking a dollar "is close to zero." Federated has never shied from acknowledging this risk, especially in its disclosures to MMF shareholders. MMF shareholders should never doubt the possibility of their fund breaking a dollar or of their suffering a loss as a result, nor should regulatory policy seek to eliminate all risks.

Federated agrees with the PWG Report's warning (at p. 13) that "[a]ttempting to prevent any fund from *ever* breaking the buck would be an impractical goal that might lead… to draco-

[6] Many of the Figures and Tables in the Report are limited to prime MMFs. This is probably because government and tax-exempt MMFs are even more stable and less likely to experience large-scale redemptions than prime MMFs. The Commission should consider such distinctions when evaluating reform proposals.

nian and—from a broad economic perspective—counterproductive measures ….” Table 2 in the Report shows further reductions in permitted WAM would not address any meaningful risks. Table 5 supports a similar conclusion with respect to increasing daily and weekly liquid assets requirements, given the nine-fold increase in the resilience of prime MMFs already accomplished by the 2010 reforms (with the percentage of funds that would break a dollar as a result of a 2008-like event falling from 66.6% to 7.4%). In the absence of any meaningful reduction in risk, it is hard to see how the Commission could justify additional reforms along these lines.

This leaves a default or similar credit event as the principal risk to a MMF's stable $1 value. The Report shows that such events are episodic and, in the absence of global financial crisis, of limited scope. Continual restrictions on MMFs or their shareholders, such as the reforms being considered by the Financial Stability Oversight Council (“FSOC”), are not appropriate responses to rare events affecting a limited number of funds. Reforms that deal with such events as they arise should be just as effective and far less burdensome.

4. “[I]t is difficult, if not impossible, to attribute the redemptions [during September 2008] to any single explanation.” (Report at 5)

The Division should be commended for acknowledging that the most serious global financial crisis since the Great Depression is not susceptible to a simple explanation. It is particularly helpful to recognize that the behavior of MMF shareholders may have been a manifestation of broader market behaviors, such as flights to quality, liquidity and transparency. We would add to these a “flight to simplicity,” which we observed at the onset of the financial crisis in the late summer of 2007, when the market withdrew from complex structured financial products without regard for the performance of their underlying assets.

The Commission should note that Figure 5 of the Report is entirely consistent with the analysis of runs provided by Treasury Strategies in a comment letter filed March 13, 2012.[7] Treasury Strategies concluded that a wide-scale “firestorm” run occurred in September 2008, culminating from a series of earlier runs on various institutions other than MMFs, and “it is unlikely that any intervention or barriers to exit will succeed in preventing the firestorm run.” The fact that the Report has independently verified Treasury Strategies' analysis of runs makes it even more important for the Commission to consider these comments carefully before proposing further MMF reforms.

5. “It is important to note that although these events [shown in Table 1 of the Report] affected money market funds and their sponsors, the events did not appear to cause systemic problems.” (Report at 15)

It was gratifying to see the Division repurpose the data regarding possible sponsor support of MMFs to reach more moderate conclusions than the headlines initially generated by this study. It is indeed “important to note … that funds may … have requested sponsor support in anticipation of shadow prices falling below a certain threshold, even though they might not have ultimately needed or accepted such support,” and to “be careful to avoid interpreting Table 1 as

[7] Available at http://www.sec.gov/comments/4-619/4619-147.pdf.

evidence that funds seeking support necessarily would have broken the buck had it not been provided." (Report at 16-17)

Federated also agrees that, when analyzing proposed reforms, the Commission should keep in mind that "more than one fund was affected by each event." (Report at 16) In fact, we recommend that the Commission carefully consider the different number of funds affected by each event. We observe only four cases on Table 1 affecting more than 10 funds. As a result of the 2010 reforms, the Commission can use Form N-MFP to identify which issuers would have a widespread impact on MMFs if they became insolvent. The Commission should use this information to enhance its risk-based oversight and examination of MMFs.

The Report is incorrect in suggesting (at p. 15) "that no money market fund broke the buck from these events and that sponsor support was not immediately disclosed." Holdings of inappropriate adjustable rate securities caused the Community Bankers MMF to break a dollar in 1994.[8] In addition, shareholders were probably aware of the sponsor's support. Our experience during these events was that customer service and sales personnel were told whether a MMF was affected by the event and, if so, what steps had been taken in response. These personnel provided this information to the shareholders' intermediaries and directly to shareholders who sought reassurance that the event would not adversely affect their fund. (For more recent events, this information would have been disseminated via a website.) The press also reported on sponsor support during several of these events. Thus, the failure of MMFs to break a dollar and ignorance of sponsor support cannot be the explanations for why "the events did not appear to cause systemic problems."

6. *Table 3 Shows the Eurozone Debt Crisis and U.S. Debt Ceiling Impasse Had No Effect on the Stability of MMFs*

Federated agrees that concerns regarding the Eurozone and the U.S. debt ceiling were not comparable to the global financial crisis. These events reflect, however, a money market that continues to be more tumultuous than it was before the financial crisis. The lack of rapid and sizable redemptions in response to these events demonstrates that MMF shareholders are not so risk adverse as some would suppose. It is also clear that these events did not perturb the operation or stability of MMFs.

7. *"Today, the typical prime fund holds over one quarter of its portfolio in [daily liquid assets] and nearly one half of its portfolio in [weekly liquid assets]. (Report at 20)*

This illustrates the inherently conservative nature of MMF portfolio managers. The fact that three-quarters of funds are also operating more than ten days under the maximum permitted dollar-weighted average maturity ("WAM"), as shown in Figure 6 of the Report, is also consistent with a conservative management style. Figure 6 further shows that, since 1994, WAMs rarely exceeded 60 days, even though the limit prior to 2010 was 90 days.

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[8] In the Matter of John E. Backlund, John H. Hankins, Howard L. Peterson, and John G.Guffey, Administrative Proceeding File No. 3-9805 (Jan. 11, 1999), available at http://www.sec.gov/litigation/admin/33-7626.txt.

These facts have two important implications. First, they suggest that MMFs have exerted a moderating influence on the money markets, which will be lost if large amounts of the cash currently held in prime MMFs are transferred to other investment alternatives. Second, they demonstrate how easy it is for the Commission to identify outlying funds, the managers of which could be examined more closely and frequently to assure they are not taking undue risks.

8. *"The additional disclosures improve fund transparency; however… [t]here does not appear to be any empirical evidence to measure the effects of this change." (Report at 31)*

The Division's willingness to admit the limits of its data must be commended. The Report underestimated, however, the degree of transparency required by the 2010 reforms. While it is true that Form N-MFP is filed on a monthly basis and is released to the public with a 60-day lag, rule 2a-7 also requires website disclosure of every MMF's portfolio within five business days of the end of each month. As noted by the Report (at p. 9), many MMFs voluntarily provided this information and interim updates throughout the financial crisis.

While we appreciate the lack of empirical evidence as to the effect of this increased transparency, it does not follow that such evidence could not be obtained for evaluation. One could ask shareholders what effect, if any, the increased transparency had on their use of MMFs or is likely to have in the event another MMF breaks a dollar. The Commission has used investor focus groups and surveys to assess other regulatory reforms (such as adoption of the summary prospectus); Federated suggests that the Commission also use these techniques to evaluate MMF reforms.

B. Significant Implications of Report

Former Chairman Schapiro repeatedly asserted that there were two "flaws inherent in the structure of money market funds:"

> First, money market funds have no ability to absorb a loss above a certain size without breaking the buck.
>
> …
>
> Second, investors of money market funds have every incentive to run at the first sign of a problem.[9]

The former Chairman apparently did not pose any questions to the Division, so she did not ask for an evaluation of her statements. The evidence and analysis provided by the Report nevertheless contradicts both of her assertions.

First, Section 2 of the Report, concerning the "Economics of Money Market Funds," explains that MMFs are not designed to absorb any losses:

[9] Statement of SEC Chairman Mary L. Schapiro on Money Market Fund Reform (Aug. 22, 2012), available at http://sec.gov/news/press/2012/2012-166.htm.

> Deviations that arise from changes in interest rates are temporary as long as securities are held to maturity because amortized costs and market values converge. If, however, a portfolio asset defaults or an asset sale results in a realized capital gain or loss, deviations between the stable $1.00 NAV and shadow NAV become permanent.

(Report at 2) The analysis goes on to acknowledge that realized losses would not be "permanent" to the extent they are offset by realized gains. Apart from such offsetting gains, however, either a MMF's shareholders or its sponsor must absorb any realized losses.

In other words, MMFs maintain a stable value by *avoiding* realized losses, not *absorbing* them. This explains why rule 2a-7 seeks to minimize: (a) the risk of a MMF realizing a loss, through risk controls such as maturity, credit and liquidity limitations, and (b) the consequences of realizing a loss, through diversification. This also explains why MMF shares are properly viewed as equity investments in a portfolio and not as deposit obligations. The absence of a loss-absorbing layer of capital in a MMF may be structural, but it is neither an oversight nor a flaw.

Second, Figures 4 and 5 of the Report belie the assertion that shareholders run at the "first sign" of a problem. Figure 5 shows the "Key Events in September [2008]," the first of which is: "9/1-2: Lehman considers asset sales and cash investors." This arguably was the "first sign" of a problem at Lehman and, consequently, the first sign of a problem for the Reserve Primary Fund. Figure 4 shows "Reserve Funds Weekly Total Net Assets" from July 1 through November 11, 2008. There is no appreciable change in these assets from August 26 to September 2, or from September 2 to September 9. The run on the Reserve Funds did not occur until the week of September 16—after Lehman's bankruptcy filing on September 15. Reserve Fund shareholders ran only after only after it became clear that the government would let Lehman fail, without stepping in as it did for Bear Stearns.

Federated believes that a review of the events listed in Table 1 would reveal that MMF shareholders are more patient than former Chairman Schapiro suggests.. Each of the listed companies and municipalities was in the news for several days, if not weeks, before the indicated event, while none of the sponsors supported their funds until after the event occurred. If the Division examined redemptions from the supported funds prior to each of these events, we would be surprised if you found any notable increase in redemptions. In our experience, shareholders are effective monitors of MMF risk and contact fund managers if they have questions about portfolio holdings; they react to actual problems in a fund's portfolio, rather than to "signs" of problems.

This behavior is significant in evaluating proposed reforms. If events that threaten a MMF's ability to maintain a stable value develop over time, and if shareholders historically have not reacted to such events until they occur, then there should be time for a MMF's board of directors (its "Board") or sponsor to respond to such events before shareholders begin to run from an affected fund. So long as the manager monitors the portfolio's risks (as already required by rule 2a-7), it should be aware of any event before it occurs. This was certainly the case with the Reserve Funds. Reports from their trial suggest the Bents were fully aware of the risk Lehman posed to their fund, but misjudged the government's willingness to rescue Lehman and therefore failed to plan for Lehman's possible failure.

In other words, the historical evidence does not support treating MMFs as though they might suddenly suffer a run before the Board or sponsor can respond to an event. This is precisely the premise of the proposals currently being considered by FSOC, which would impose onerous restrictions on a MMF's valuation or liquidity, or exorbitant capital requirements, on a daily basis to protect against events that rarely occur and affect only a handful of MMFs. The evidence of the Report strongly suggest that a "triggered" approach—imposition of restrictions only as events threatening the ability to maintain a stable NAV arise—would be sufficient to prevent any potential "first mover advantage."

II. QUESTIONS NEEDING FURTHER RESEARCH AND ANALYSIS

Given the speed with which the Division responded to the commissioners' questions, it is understandable that the Division largely limited its research to information already on file with the Commission. More information was readily available to the Division, however, from the comment letters filed in response to the PWG Report and from those who commented, as well as from the industry. Federated recommends that the Division use these sources to fill gaps in its analysis (e.g., the effects of increased transparency) or to refine its analysis (e.g., studying the effects of the 2010 amendments on portfolio management). We also suggest a more critical approach to the academic literature.

Before discussing how the Division might obtain more information, however, we will address the areas where the Division did not fully appreciate the implications of the data it had already gathered: namely, the likelihood that reforms could cause investors to transfer substantial amounts from MMFs to alternative investments and the likely impact of such transfers on the credit markets.

A. The Report Underestimated the Effects of Substantial Transfers of Cash from MMFs to Alternative Investments

Section 4.C of the Report, which analyzes the investment alternatives that investors might shift to as a result of MMF reform, shares some of the defects of FSOC's "Considerations of the Economic Impact of [Its] Proposed Recommendations on Long-Term Economic Growth." [10] Both assessments are, at once, too narrow and too broad, too tentative and too assertive. Federated suggests that the Division carefully reconsider this section of the Report, particularly if asked to provide a cost/benefit analysis of specific reform proposals.

This section is too narrow in that it examines only current market conditions. Global financial markets have not fully recovered from the financial crisis. The credit markets remain particularly weak, as evidenced by the Federal Reserve's extraordinary monetary policies, high levels of cash held by businesses (as shown in Figure 18 of the Report) and unprecedented excess reserves currently held by banks (nearly $1.5 trillion[11]). The slow pace of the economic

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[10] Proposed Recommendations Regarding Money Market Mutual Fund Reform, *supra* n.5 at Part VI.

[11] Federal Reserve Statistical Release H.3, available at http://www.federalreserve.gov/releases/h3/current.

recovery has dampened demand for credit. Furthermore, Federated believes that uncertainty as to the future of MMFs have deterred some companies from relying on them for funding.

The Division should broaden its historical horizons when assessing the importance of MMFs to the credit markets. The Investment Company Institute's ("ICI") 2012 Investment Company Fact Book shows (in Table 44) that, from the mid-1980s through the 1990s, a period of economic expansion, commercial paper represented more than 50% of prime MMF holdings. Funding from MMFs contributed to economic growth during this period, and will do so again when the economic recovery gains strength. The Division should analyze the impact of a large-scale withdrawal of cash from prime MMFs under conditions of normal economic growth, rather than limiting its analysis to the near recessionary conditions that currently prevail.

The Division should also broaden its view of how prime MMFs finance non-financial companies. Section 4.C.2 focuses exclusively on commercial paper. Table 44 in the Investment Company Fact Book shows, however, that at the end of 2011, another 6.3% of prime MMF assets were invested in corporate notes (exclusive of bank notes). This suggests that nearly half of the $228.22 billion invested by prime MMFs in "Other" assets, as shown in Table 7 of the Report, may represent funding of non-financial companies.

Section 4.C.2 is too broad insofar as it assesses prime MMFs in the context of the entire credit market, rather than the short-term sector in which the funds predominate. Commercial paper financing by non-financial businesses may currently be "a small portion (one percent) of their overall credit instruments" (Report at 49), but this does not mean that commercial paper is not important.[12] There are reasons that non-financial companies issue commercial paper rather than other credit market instruments, and these companies would view the loss of this source of funding as significant. From this perspective, the fact that MMFs hold 58% of non-financial commercial paper outstanding on March 31, 2012,[13] indicates that a substantial reduction in MMF assets could have serious repercussions for these companies.

Municipal issuers provide another illustration of the shortcomings of the Division's approach to this question. The Report analyzes trends in the entire market for municipal bonds. This misses, among other things, the vital role played by MMFs in funding tax and revenue anticipation notes ("TRANs"). Many local governments and school districts rely heavily on property taxes, which they assess and collect once a year, and similar periodic sources of revenue. These municipal entities issue TRANs to fund day-to-day expenditures throughout the year and repay the TRANs when they receive property taxes or other revenues. Federal tax laws do not permit municipalities to issue long-term tax-exempt bond to bridge such funding gaps. The only alternative source of funding available for this purpose is a short-term loan from a bank.

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[12] This is another instance were the Division would benefit from a broader historical context. Companies holding the levels of cash shown in Figure 18 do not need short-term funding. Commercial paper represents a larger portion of overall credit during normal economic and market conditions.

[13] Note 90 of the Report states that non-financial commercial paper totaled $127.6 billion as of March 31, 2012, and Table 7 of the Report shows all MMFs holding $73.88 billion of non-financial company commercial paper on this date.

In 2011, state and local governments issued $60.7 billion of short-term notes.[14] Table 7 shows that on March 31, 2012, when most of these short-term notes would still have been outstanding, MMFs held $60.1 billion of "Other Municipal Debt." While Other Municipal Debt includes instruments other than short-term notes, such as municipal commercial paper, the magnitude of their holdings indicate that MMF held a substantial portion of these short-term notes. In addition, it is common for large issuances of TRANs to be restructured as tender option bonds, so some portion of the $292 billion of VRDNs held by MMF also consisted of these short-term notes.

When Federated first introduced tax-exempt MMFs in 1976, banks routinely charged interest in excess of the prime rate for short-term loans to state and local governments. State and local governments now issue TRANs paying interest at a small fraction of the prime rate. We conservatively estimate that MMFs hold, on average, more than two-thirds of the outstanding TRANs. Without this funding from MMFs, short-term funding costs for municipal issuers could return to levels much closer to the prime rate. The current average yield reported by The Bond Buyer for short-term municipal notes is 0.22%, as compared to the current prime rate of 3.25%.

Section 4.C.1 is too tentative in assessing the probable response of MMF shareholders to a floating NAV or to liquidity restrictions. Extraordinarily low interest rates currently permit MMFs to provide only minuscule returns to their shareholders. According to iMoneyNet, the average yield on taxable MMFs is two basis points. This means that, at this time, shareholders have only three reasons to use MMFs for cash management: stability, daily liquidity and diversification. The ease of operations that results from a stable value and daily liquidity is a prerequisite to efficient cash management. As Table 6 of the Report shows, higher yielding alternatives with fluctuating values and/or liquidity restrictions are currently available to MMF shareholders. These shareholders have demonstrated their preference for stability and liquidity over yield by staying in MMFs. Figure 18 of the Report, showing a nearly dollar-for-dollar shift in cash held by non-financial business from MMFs to checkable bank deposits, further buttresses this conclusion, as does the 2012 AFP Liquidity Survey cited in the Report (at pp. 45-46), showing a 20% decline in MMFs and a 25% increase in bank deposits since 2008.

Thus, all of the evidence cited in the Report supports the conclusion that most current shareholders have a strong preference for stability and daily liquidity. They will therefore not remain in MMFs if the funds are forced to float their NAV or impose liquidity restrictions such as a minimum balance requirement. The Report contains no evidence to the contrary. Moreover, the same evidence argues that shareholders will not shift their cash from MMFs to any cash investment alternative shown in Table 6 that does not have "Stable" under the Valuation column and "No" under the Redemption Restriction columns. This implies that most of the cash would be moved to bank demand deposits, STIFs, LGIPs and private enhanced cash funds (including offshore MMFs).

As Table 6 shows, the investor base for STIFs, LGIPs and private enhanced cash funds is restricted. These restrictions will prevent retail shareholders and all but the largest institutional

[14] The Bond Buyer 2012 Yearbook at 25.

shareholders from shifting to these alternatives. This leaves bank accounts as the only realistic alternative for these shareholders. The Report acknowledges that large-scale transfers from MMFs to banks "would increase reliance on FDIC deposit insurance and increase the size of the banking sector, which raises additional concerns about the concentration of risk in the economy." (Report at 45) In other words, these reforms would increase a known systemic risk in an attempt to prevent a speculative systemic risk. Shifting money to banks would also increase the risks to investors whose cash holdings exceed the $250,000 federal deposit insurance limit insofar as they could not practically replicate the diversification provided by a MMF.

This likely shift of substantial amounts of cash from MMFs to banks makes the Report's claim (at p. 47) that "shifts in investor capital to alternative investment instruments are likely to increase demand for these same assets reducing the net effect on the short-term funding market," too assertive. Bank portfolios are not "limited to the same securities in which money market funds invest." Banks may find other lending and investment opportunities that offer better risk adjusted returns than commercial paper or other forms of short-term funding. Thus, the evidence cited by the Report does not show that shifts to alternative investments "are likely" to increase the demand for assets currently held in MMFs. The "spillover effects from investors substituting away from money market funds and money market fund contraction" are more likely to be negative than neutral.

Finally, Section 4.C is too tentative insofar as it fails to draw any conclusion about the effect of substituting less regulated and transparent investment alternatives—STIFs, LGIPs and private enhanced cash funds—for MMFs. Lack of uniform portfolio limitations and transparency make these investment alternatives more prone to runs than MMFs. Whereas *one* MMF broke a dollar in September 2008, *several* LGIPs and private enhanced cash funds broke a dollar in the autumn of 2007 and more were closed after suffering runs during this period. Bailouts of STIFs were also reported. Thus, as the PWG Report warned, reforms that shift cash from MMFs to these investment alternatives would be counterproductive, insofar as they would increase the risk of investor runs.

B. <u>The Division Should Not Limit Its Analysis to Data from SEC Filings</u>

The Division based much of its analysis on information derived from Form N-SAR. In particular, the Division used this information to determine distributions of fund WAMs, holdings of daily and weekly liquid assets, holdings of various types of investments, and shadow NAVs. Footnotes 30 and 36 of the Report note some of the limitations of this data, such as the semiannual frequency of the report. Another problem is that Form N-SAR is filed based on the fund's fiscal year, so the filings cover different periods for funds with different fiscal years. Most importantly, Form N-SAR was not designed to provide much of the data required for the Divisions analysis, such as holdings of daily or weekly liquid assets. This forced the Division to work with assumptions and estimates rather than actual values.

Federated could provide more complete and accurate information for its MMFs than Form N-SAR. For example, Rule 2a-7 requires the Board to monitor shadow NAVs, so Federated provides a quarterly report at each Board meeting with all of its MMFs' shadow NAVs. These reports would provide shadow NAVs for all Federated MMFs on at least a bi-weekly basis for the period covered by Figure 16 of the Report. Federated's accounting systems

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could also provide the Division with detailed portfolio information, including WAMs and daily and weekly liquid assets, for a substantial period before the 2010 reforms required this information to be reported on Form N-MFP. We believe other advisers could also provide this data.

We understand that the ICI offered to assist the Commission in assembling information responsive to the commissioners' questions. We encourage the Division to accept such offers of assistance, to gain a more accurate and complete understanding of MMFs. Federated will fully cooperate with such efforts and will encourage other managers to do the same.

C. The Division Should Make Use of Comment Letters on the PWG Report

Hundreds of substantive comment letters (in addition to thousands of comments simply expressing opposition to further reforms) were filed in response to the PWG Report. Federated even filed a comment letter that categorized and summarized the comment letters.[15] Although the Report confirms many of the points raised by these comments, the Report does not cite any comments or indicate that they were reviewed in conjunction with the Report. If the Division has not already done so, it should review these comments, as they provide a wealth of information and analysis. The effort will be worthwhile if the Commission decides to propose further MMF reforms, insofar as it must consider these comments when proposing reforms and when completing the initial cost/benefit analysis required for any proposal.

The comment letters addressed many of the matters covered by the Report, such as the likely reaction of shareholders to a floating NAV or redemption restrictions. (Most shareholders who commented said they would stop using or reduce their use of MMFs). Commenters also provide the Division with a means of supplementing its information. We would expect, for example, that the National Association of State Treasurers, which filed comments on December 21, 2011 and joined in two subsequent comment letters, could provide an accurate estimate of the amount of state issued TRANs held by MMFs and the cost of alternative funding. The Division should ask commenters for any missing information that would help the Division in its analysis.

D. The Division Should Examine Shareholder Behavior in More Detail

The Report persists in viewing MMF shareholders as coming in only two varieties: institutional and retail. This view reflects the categories used by the ICI, iMoneyNet and other public sources of MMF data. As Federated showed in its comment letter on the 2010 reforms, these categories obscure more than they illuminate.[16] If the Division looked at trading in MMF shares by "social code," it would find that shareholder activity was more diverse than the simplistic institutional/retail dichotomy would suggest. There is no reason to suppose that corporate treasurers, municipal treasurers, indenture trustees, corporate trustees, collateral agents and securities lending agents (to name just some of the entities that fall into the "institutional" category) all behave in a uniform manner. Analysis of more detailed trading data would have confirmed this intuition.

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[15] Available at http://sec.gov/comments/4-619/4619-213.pdf.

[16] Available at http://www.sec.gov/comments/s7-11-09/s71109-104.pdf, at 9.

It would also have tested the unsubstantiated hypothesis that institutional investors sought to "take advantage" of retail investors in commingled funds. (Report at 10)

E. The Division Should Examine Portfolio Management Practices

Although the Division recognized that various factors contribute to a MMF's ability to maintain a stable value, the Report treats these factors as given, rather than as the product of portfolio management. For example, the stability of shadow NAVs shown in Figure 16 is due in large part to portfolio management decisions, such as the substantial reduction in WAMs at the beginning of 2004 shown in Figure 6 in response to the Federal Reserve's tighter monetary policies. We expect that a review of the more detailed information discussed in the previous sections would also show that portfolio managers increased their holdings of daily and weekly liquid assets substantially at the outset of the financial crisis in 2007. If this was the case, then their actions helped to mitigate the liquidity crunch at the peak of the crisis in September 2008.

This blind spot in the analysis reflects a corresponding blind spot in the Commission's reform efforts. As far as we are aware, the Commission has not worked with MMF portfolio managers or Boards to augment their management of fund risks. For example, the ICI's Money Market Working Group Report in 2009 included Best Practices for Determining Minimal Credit Risks under Rule 2a-7. A recommendation by the Commission that MMF Boards and managers review and implement these best practices may do more to immediately reduce the credit risks taken in MMFs than any proposed capital requirement.

F. The Division Should Independently Confirm the Findings of Non-Peer Reviewed Academic Articles

The Report treats working and discussion drafts of articles (e.g., Chernenko, Sergey, and Adi Sunderam, September 2012, Frictions in Shadow Banking: Evidence from the Lending behavior of Money Market Funds, Working paper No. 2012-4, Fisher College of Business) and articles from peer reviewed journals (e.g., Chen, Qi, Itay Goldstein, and Wei Jiang, 2010, Payoff Complementarities and Financial Fragility: Evidence from Mutual Fund Outflows, Journal of Financial Economics, V 97, 239-262) as equally authoritative. This is not a sound practice for developing regulatory policy. The ICI, for example, has raised important questions concerning the methodology used by Chernenko and Sunderam that would invalidate their counterintuitive conclusions regarding the impact MMF risks on "creditworthy issuers." The authors have yet to respond to these questions.

We do not object to the Division including non-peer reviewed articles in the Report, but believe it should have considered such articles more critically. The Division should try to confirm the findings reported in such articles or at least should consult with other knowledgeable sources (such as the ICI) regarding the reliability of their findings. In fact, the Division should carefully evaluate any article or study by anyone who does not have direct experience with MMFs or the money markets.

III. CONCLUSION

Federated hopes that the Report will lay to rest many persistent misconceptions concerning MMFs. Such misconceptions include the claim that a MMF's stable value results from an

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"accounting gimmick," rather than the natural convergence of market value and amortized cost discussed on page 2 of the Report and the intrinsically low volatility of MMF portfolios shown in Figure 16 and in Table 2. Section 3 of the Report should end the presumption that shareholders will automatically run from their MMF solely because an unrelated fund has broken a dollar. Section 4 shows conclusively that the 2010 reforms included effective measures to reduce the risks of MMFs, particularly interest rate and liquidity risks. The 2010 reforms remain the first, and perhaps still the most significant, steps taken by any federal regulator to address some of the concerns raised by the financial crisis.

Federated also hopes the Division will expand the information it uses to analyze MMFs and reform proposals, and will not shy from drawing reasonable inferences regarding the potential impact of reforms based on this information. We expect the Division will play an important role in analyzing any reform proposals considered by the Commission and will assist in the required analysis of their expected costs and benefits. If the Division continues to match the standards for transparency and candor exemplified by the Report, its input should help guide the Commission to those reforms, if any, that best advance the interest of investors, increase market efficiency and promote capital formation.

Finally, we must note the difficulty of imagining any SEC Chairman who fully understands the Report and its implications voting in favor of any of the proposed reforms currently being considered by FSOC. If our interpretation of the evidence presented in the Report is correct, there is no justification for imposing capital requirements or preventing funds from redeeming all of their shares at a stable value on a daily basis. None of FSOC's proposed reforms would further the goals of investor protection, capital formation and market efficiency. In fact, these reforms would work against the Commission's paramount goals.

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

Yours very truly,

/s/ John W. McGonigle
Vice Chairman

cc: Chairman Elisse B. Walter
Commissioner Luis A. Aguilar
Commissioner Daniel M. Gallagher
Commissioner Troy A. Paredes
Director Norm Champ