

September 13, 2013

The Honorable Mary Jo White
Chair
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549-1090

Re: **Proposed Rule on *Money Market Fund Reform; Amendments to Form PF*;
Release No. S7-03-13
Problems with the Floating NAV**

Dear Chair White:

We are writing on behalf of our client, Federated Investors, Inc., and its subsidiaries (“Federated”), to provide comments in response to the Securities and Exchange Commission’s (the “Commission’s”) proposed rule on *Money Market Fund Reform; Amendments to Form PF* (the “Release”).¹ Our comments in this letter will focus specifically on the proposed rule’s requirement that money market mutual funds (“MMFs”) adopt a floating net asset value (“NAV”), and price their shares to the fourth decimal place (*e.g.*, \$1.0000), unless specifically exempted.

The proposed rule would exempt from the floating NAV requirement U.S. “government” MMFs and “retail” MMFs, as those types of funds are defined in the Release.² The floating NAV requirement would apply to tax exempt MMFs, unless those funds satisfy the proposed definition of a “retail” MMF. In addition, the proposed rule would eliminate use of the amortized cost method of accounting by MMFs except to the extent that other mutual funds are able to use it – where the MMF’s board of directors determines, in good faith, that the value of

¹ *Money Market Fund Reform; Amendments to Form PF*, 78 Fed. Reg. 36834 (June 19, 2013) (“Release”).

² A MMF is defined as a U.S. Government MMF under the proposed rule if and so long as eighty percent or more of the MMF’s total assets are invested in cash, government securities, and/or repurchase agreements that are collateralized fully. A MMF is defined as a retail fund under the proposed rule if the fund does not permit any shareholder of record to redeem more than \$1,000,000 per business day. A forthcoming letter will discuss Federated’s position that these exemptions and other aspects of Alternative One do not, in fact, alleviate its disruptive effects.

September 13, 2013

Page 2

debt securities with remaining maturities of 60 days or less is their amortized cost, unless the particular circumstances warrant otherwise.³ Under the floating NAV proposal, government and retail MMFs would continue to be permitted to penny-round their shares. The Release refers to this proposed alternative as “Alternative One.”

The Release gives two principle rationales for requiring certain MMFs to adopt a floating NAV. First, the Release states that the floating NAV proposal “is designed primarily to address the incentive of money market fund shareholders to redeem shares in times of fund and market stress based on the fund’s valuation and pricing methods”⁴ Second, the Release states that, “Depending on the degree of fluctuation, this precision [of valuing MMF shares to the fourth decimal point] would increase the observed sensitivity of a fund’s share price to changes in the market values of the funds’ portfolio securities, and should better inform shareholders of the floating nature of the fund’s value.”⁵

As discussed in further detail below, despite declaring as its primary goal the prevention of runs, the Release acknowledges that “a floating NAV may not eliminate investors’ incentives to redeem fund shares, particularly when financial markets are under stress and investors are engaging in flights to quality, liquidity, or transparency.”⁶ The Release offers no evidence that floating NAV MMFs are less susceptible to large-scale redemptions, and in the end relies on an argument about the “incentive” to redeem, which could create a “first-mover advantage,” that the Release says is created by the stable NAV of MMFs. But, as discussed below, the Commission’s existing rules are the appropriate mechanism to address any “first-mover advantage,” and Alternative Two of the proposal, for which we separately have recommended modifications, more directly and effectively addresses the Commission’s concerns regarding the protection of slower moving shareholders from the risk of large-scale redemptions from a prime MMF and will neither drive investors from MMFs nor have massive implementation costs. Moreover, the Release’s secondary rationale, that a floating NAV is necessary to provide transparency to MMFs and to make investors aware that shares can fluctuate, ignores the explicit disclosures currently provided by MMFs and existing survey data demonstrating that even retail investors

³ Release at 36849. *See Valuation of Debt Instruments by Money Market Funds and Certain Other Open-End Investment Companies*, Investment Company Act Release No. 9786 (May 31, 1977).

⁴ Release at 36849.

⁵ *Id.*

⁶ *Id.* at 36549-50.

September 13, 2013

Page 3

understand that MMF shares can fluctuate in value. Of course, there is no doubt that institutional investors – the target of the floating NAV proposal – understand this fact.

Although the proposed floating NAV requirement offers no real benefits for investors or the economy, the costs of implementing a floating NAV for MMFs, intermediaries, transfer agents, and investors will be enormous. The proposed floating NAV would force significant retooling of systems throughout the MMF transaction process. Moreover, the proposed rule and the Release do not alleviate or address the substantial tax, accounting, and legal burdens associated with the floating NAV requirement. These issues would need to be completely resolved and the resolutions implemented – not merely discussed – before a floating NAV could be imposed, unless the regulatory goal is to eliminate or drastically reduce the assets of MMFs.

As discussed in more detail below, the Commission should not adopt the floating NAV alternative for MMFs for the following reasons:

- (1) A floating NAV would do nothing to advance the regulatory goal of reducing or eliminating large scale redemptions from a MMF.
- (2) A floating NAV would only serve to tell investors something they already know – that MMF shares can fluctuate – and would not affect investor behavior in times of stress.
- (3) The potential for a “first-mover advantage,” upon which the Commission bases its floating NAV proposal, cannot develop under Rule 2a-7 unless a MMF’s board fails to do its job. While Federated does not believe that further structural reforms are necessary, Alternative Two (with certain modifications) is the only current alternative that would directly and effectively address this concern.
- (4) A floating NAV will not produce “mark-to-market” prices for MMF portfolio instruments or for MMF shares. Instead, it will generate time-consuming and costly processes to derive market-based “good faith opinions” from pricing vendors of the valuation of MMF portfolio instruments, from which to calculate the required MMF NAVs.
- (5) A floating NAV for MMF transactions will result in undue reliance by MMFs upon pricing vendors, making them the new rating agencies, with risks and consequences the Commission has failed to consider.

September 13, 2013

Page 4

- (6) A floating NAV, which relies upon “market-based” estimates, will yield insignificant and irrelevant fluctuations – essentially “noise” in the estimated valuations.
- (7) To the extent “market-based” valuations have an informational value for investors – principally to demonstrate that the underlying portfolio instruments and the MMF’s underlying “market-based” NAV fluctuate in value – investors already have access to this information and will have even more, if the Commission requires daily shadow NAV disclosure for all MMFs.
- (8) A floating NAV would impose significant daily operational burdens on MMF users, intermediaries, and MMFs. It will destroy MMFs as a cash management tool and lead to significant and disruptive disintermediation.
- (9) Using “market-based” estimates to create floating MMF NAVs with insignificant fluctuations will push back settlement times by hours or even overnight, increasing costs, burdens, and risks, including risks in payment systems and markets.
- (10) The Commission’s proposal for MMF pricing at a floating NAV to the fourth decimal point suggests a level of accuracy, or “precision,” that is misleading to investors. An NAV calculated to the fourth decimal point, derived from “good faith opinions” of the “market-based” valuations of MMF portfolio instruments, is nonetheless an estimate and no more accurate than an amortized cost based NAV.
- (11) A floating NAV would create accounting uncertainty and substantial daily tax and recordkeeping burdens for users of MMFs and destroy their utility and efficiency. These issues remain unresolved in the Release.
- (12) A floating NAV would altogether prevent certain investors who are subject to statutory prohibitions and investment restrictions from using prime MMFs.

September 13, 2013

Page 5

(1) A floating NAV would do nothing to advance the regulatory goal of reducing or eliminating large scale redemptions from a MMF.

Throughout the Release, the Commission points to the importance of the report prepared in response to the questions posed by Commissioners Aguilar, Paredes, and Gallagher (“RSFI Study”)⁷ in both assessing the effectiveness of the Commission’s 2010 amendments to its MMF rules and informing the Commission’s formulation of the proposals in the Release.⁸ Indeed, the Release points to one of the most important conclusions of the RSFI Study as the central premise for further MMF reform:

[W]hile the 2010 reforms were an important step in making money market funds better able to withstand heavy redemptions when there are no portfolio losses (as was the case in the summer of 2011), *they are not sufficient to address the incentive to redeem when credit losses are expected to cause funds’ portfolios to lose value or when the short-term financing markets more generally are expected to, or do, come under stress.*⁹

If this is the central premise upon which both the need for further reform and the design of specific reforms is based, then the proposed reforms must, in fact, be designed to prevent large-scale redemptions in the event of a credit loss leading to a loss in a MMF portfolio or in circumstances in which the markets are under stress. But, the Commission acknowledges that a floating NAV does not do this: “We recognize that a floating NAV may not eliminate investors’ incentives to redeem fund shares, particularly when financial markets are under stress and investors are engaging in flights to quality, liquidity, or transparency.”¹⁰

⁷ Division of Risk, Strategy and Financial Innovation, Response to Questions Posed by Commissioners Aguilar, Paredes, and Gallagher (Nov. 30, 2012), <http://sec.gov/news/studies/2012/money-market-funds-memo-2012.pdf> (“RSFI Study”). Federated previously has commended the SEC staff on its report, and provided comments on that report. Letter from Federated Investors to SEC (Jan. 7, 2013) (available in SEC file for 2012 Special Studies).

⁸ See, e.g., Release at 36848.

⁹ Release at 36848 (emphasis added).

¹⁰ *Id.* at 36581 (citing the President’s Working Group Report and the SEC’s own 2009 Proposing Release). The SEC further acknowledges that “incentives other than those created by money market fund’s stable share price exist for money market fund shareholders to redeem in times of stress, including avoidance of loss and the tendency of investors to engage in flights to quality, liquidity, and transparency.” *Id.* at 36850.

September 13, 2013

Page 6

We agree with the Commission's statement in the Release. We and other commenters previously advised the Commission that the only available comparative data on this issue – which analyze the behavior during the financial crisis of floating NAV funds in Europe and ultra short bond funds in the United States – make this very point.¹¹ Indeed, it is noteworthy that the

¹¹ Letter from HSBC to FSOC (Feb. 15, 2013) (available in File No. FSOC–2012–0003) (reviewing the performance of French *monétaire* funds from 1999 to 2009 and stating that “we cannot find any evidence for the argument that there are substantial differences between CNAV and VNAV funds, which cause CNAV funds to be more prone to run risk than VNAV funds.”); Letter from Invesco to FSOC (Feb. 15, 2013) (available in File No. FSOC–2012–0003) (citing the experience of ultra short bond funds and French floating NAV dynamic money funds and stating, “History demonstrates that a floating NAV does not necessarily reduce investors’ incentive to redeem during periods of market stress.”); Letter from Fidelity Investments to FSOC (available in File No. FSOC–2012–0003) (“[T]he FSOC has not provided, nor are we aware of, empirical evidence to support the idea that in a period of market turmoil, funds with floating NAVs would be at lower risk of significant redemptions from shareholders.”). See also Letter from Fisch & Roiter to SEC (Dec. 2, 2011) (available in File No. 4-619). The Commission dismisses comparative data by stating that 2a-7 floating NAV funds would have different risk-limiting characteristics than either European floating NAV funds or ultra short bond funds. The Release instead chooses to isolate the experience of French *monétaire* funds, which generally did not experience heavy redemptions during the financial crisis, rather than all European funds, as analogous to U.S. MMFs adopting a floating NAV. Release at 36852. The Release also cites a single study to suggest that there is disagreement in the empirical data on the performance of similar investment products (a study which, in fact, also compares the performance of U.S. and European MMFs during critical periods). Jonathan Witmer, *Does the Buck Stop Here? A Comparison of Withdrawals from Money Market Mutual Funds with Floating and Constant Share Prices*, Bank of Canada Working Paper 2012–25 (Aug. 2012), <http://www.bankofcanada.ca/wp-content/uploads/2012/08/wp2012-25.pdf>. This Bank of Canada staff paper concludes that there is a small but statistically significant correlation between use of CNAV and sustained redemptions from MMFs of 1% over three consecutive business days. The study concludes that the correlation is smaller for larger percentage redemptions and for euro-denominated MMFs. In view of the high liquidity levels held by MMFs under the 2010 amendments to Rule 2a-7 (requiring at least 10% overnight and 30% 7-day liquidity and under 60 days WAM), sustained net redemptions of 1% per business day for six weeks or more can readily be met from portfolio liquidity of a MMF without sale of assets. The data adduced by the staffs of the Federal Reserve and the Bank of Canada, whose leadership includes many of the harshest critics of CNAV MMFs, does not support a conclusion that CNAV MMFs are more subject to destabilizing “runs” than are VNAV MMFs. In fact, the work of a significant number of scholars supports the conclusion that *liquidity*, not a particular NAV structure, prevents runs. Hal Scott, *Interconnectedness and Contagion*, *Committee on Capital Markets Regulation* at 222-24 (Nov. 20, 2012), http://www.capmksreg.org/pdfs/2012.11.20_Interconnectedness_and_Contagion.pdf; Stephan Jank & Michael Weddow, *Sturm und Drang in Money Market Funds: When Money Market Funds Cease to be Narrow*, Deutsche Bundesbank Discussion Paper Series 2: Banking and Financial Studies No. 20/2008 (2008); Fitch Ratings, *Study of MMF Shadow NAV Shows Stability* (June 14, 2012), <http://www.fitchratings.com/web/en/dynamic/articles/Study-of-MMF-Shadow-NAV-Shows-Stability.jsp>. This conclusion is consistent with the analysis in an FDIC Staff paper that insufficient liquidity, rather than capital, is the best predictor of financial panics in the banking system. See Kathleen McDill and Kevin Sheehan, *Sources of Historical Banking Panics: A Markov Switching Approach*, FDIC Working Paper 2006-01 (Nov. 2006), http://www.fdic.gov/bank/analytical/working/wp2006_01/wp2006_01.pdf. Moreover, an academic study similar to

Footnote continued on next page

September 13, 2013

Page 7

strongest advocates for MMF reform – the Financial Stability Oversight Council (FSOC),¹² the Federal Reserve Bank of New York,¹³ and various academics,¹⁴ uniformly concede that requiring MMF investors to transact at a floating NAV will not prevent or reduce the risk of large scale redemptions from a MMF, nor is there any data to suggest that it will.

Lacking evidence that a floating NAV will prevent or reduce the risk of heavy redemptions during market stress, the Release puts forward the rationale that a floating NAV will address the “incentives” shareholders have to redeem shares from a stable NAV MMF in circumstances where the shadow NAV “deviates far enough,” so that the “shrinking asset base” created by shareholder redemptions could cause a MMF to “break a buck.” However, shareholders in a floating NAV MMF surely would have the same incentive to redeem if a floating NAV MMF “deviates far enough” from the typical historical range for market-based pricing, particularly if they believe the MMF could continue to drop in value. Indeed, one might argue that such shareholders have even greater incentives to redeem from a declining floating NAV MMF, because small declines in the NAV are realized in a floating NAV MMF, while in a stable NAV MMF they are not. As Commissioner Paredes observed, “The bottom line under a

Footnote continued from previous page

Witmer’s found that the NAV feature of MMFs did not explain the likelihood of investors to run during “Lehman week.” Letter from Jeffrey Gordon to FSOC (Feb. 28, 2013) (available in File No. FSOC–2012–0003) (“One common reform proposal has been to substitute “floating NAV” for “fixed NAV,” on the view that MMF run risk was strongly affected by the potential to arbitrage between the “true” value of MMF assets and the \$1 fixed NAV. It turns out that European MMFs are issued in two forms, “stable NAV” and “accumulating NAV,” which offer a reasonable proxy for the distinction between fixed and floating NAV. Thus the comparative run rate of these two MMF types during “Lehman week” offers a natural experiment of the effect of NAV “fixedness.” We find that the stable/accumulating distinction explains none of the cross-sectional variation in the run rate among these funds.”).

¹² Proposed Recommendations Regarding Money Market Mutual Fund Reform, 77 Fed. Reg. 69455 (Nov. 19, 2012) (“[W]hile a floating NAV would remove the ability of a shareholder to redeem shares at \$1.00 when the market value is less than \$1.00, it would not remove a shareholder’s incentive to redeem whenever the shareholder believes that the NAV will decline significantly in the future, consistent with the incentive that exists today for other types of mutual funds.”).

¹³ Patrick E. McCabe, et al., *The Minimum Balance at Risk: A Proposal to Mitigate the Systemic Risks Posed by Money Market Funds*, Federal Reserve Bank of New York Staff Study No. 564 at 6, 54 (July 2012), <http://www.federalreserve.gov/pubs/feds/2012/201247/201247pap.pdf> (“[E]ven if MMFs with floating NAVs remain sizable, they might continue to be vulnerable to runs, since investors in distressed funds still would have strong incentives to redeem.”).

¹⁴ Letter from Samuel G. Hanson, David S. Scharfstein, and Adi Sunderam to FSOC (December 20, 2012) (available in File No. FSOC-2012-0003) (“Introducing floating NAVs would not . . . reduce incentives to run . . .”).

September 13, 2013

Page 8

floating NAV, then, is that when investors see signs of stress, they will have an incentive to redeem sooner rather than later before the NAV floats downward. At a time of stress, even investors that are accustomed to seeing a fund's NAV fluctuate may redeem if they expect the fund's price to fall."¹⁵ Commissioner Daniel Gallagher also acknowledged that the "only way to ensure that a run is stopped in its tracks is to permit gating."¹⁶

If the Commission's "incentives" theory is to be the basis for major structural changes in MMFs, then the Commission, at minimum, needs to demonstrate that a declining shadow NAV in a stable NAV MMF provides a substantially *greater* incentive for shareholders to redeem to avoid a loss than a floating NAV MMF that is deviating downward in similar amounts from a MMF's historical and anticipated range. The Release does not do this; the "incentives" theory underlying the Commission's floating NAV proposal is purely speculative and will not support the dramatic structural changes in MMFs proposed in the Release. Indeed, the Release's incentives theory, which ultimately serves as a principle rationale for the adoption of the floating NAV, is unlikely to fulfill the Commission's obligation to "support its predictive judgments" in the rulemaking process.¹⁷

¹⁵ Troy A. Paredes, *Statement at Open Meeting Regarding a Rule Proposal on Money Market Fund Reform* (June 5, 2013), <http://www.sec.gov/news/speech/2013/spch060513tap.htm>.

¹⁶ Daniel M. Gallagher, *Statement at the SEC Open Meeting on Money Market Fund Reform* (June 5, 2013), <http://www.sec.gov/news/speech/2013/spch060513dmg.htm>. Commissioners Paredes and Gallagher also earlier questioned the efficacy of the floating NAV in addressing investor incentives to redeem, pointing out that the "predominant incentive of investors in a crisis to flee risk and move to safety," and stating, "Even if there is no stable \$1.00 NAV – i.e., even if, by definition, there is no 'buck' to break – investors will still have an incentive to flee from risk during a crisis period such as 2008, because investors who redeem sooner rather than later during a period of financial distress will get out at a higher valuation." Daniel M. Gallagher and Troy A. Paredes, Commissioners, Securities and Exchange Commission, *Statement on the Regulation of Money Market Funds* (Aug. 28, 2012), <http://www.sec.gov/news/speech/2012/spch082812dmg.htm>.

¹⁷ *Business Roundtable v. SEC*, 647 F.3d 1144, 1149 (D.C. Cir. 2011).

September 13, 2013

Page 9

(2) A floating NAV would only serve to tell investors something they already know – that MMF shares can fluctuate – and would not affect investor behavior in times of stress.

The Release’s secondary justification for requiring certain MMFs to adopt a floating NAV is to “increase the transparency of money market fund risk.”¹⁸ The Release builds the argument for the need for additional transparency first by claiming that “survey data shows that some investors are unsure about the amount of risk in money market funds and the likelihood of government assistance if losses occur.”¹⁹ The Release then appears to suggest, without evidence, that *institutional* investors have become confused about the degree of risk in MMFs, arguing that sponsor support has “implicitly encouraged” institutional investors to view MMFs as “‘risk-free’ cash.”²⁰ The Release then speculates that because institutional investors “were not accustomed to seeing their funds lose value, [they] may have increased their redemptions of shares when values fell in recent times.”²¹ The Release then declares that a floating NAV would increase the transparency of MMFs because –

- It “*could* alter investor expectations by making clear that money market funds are not risk free and that the funds’ share price will fluctuate based on the value of the funds’ assets,”²²
- With the additional information supplied by a floating NAV, investors “*should* become more accustomed to, and tolerant of, fluctuations in money market funds’ NAVs,”²³ and
- Investors “thus *may be* less likely to redeem shares in times of stress.”²⁴

¹⁸ Release at 36850.

¹⁹ *Id.*

²⁰ *Id.* at 36851.

²¹ *Id.*

²² *Id.* (emphasis added).

²³ *Id.* (emphasis added).

²⁴ *Id.* (emphasis added).

September 13, 2013

Page 10

Although the Release uses tentative language and does not attempt to overstate these projected benefits, the projected benefits nonetheless are purely speculative, without foundation, and contrary to the substantial evidence that investors are aware of the fact of small fluctuations in the portfolio values of MMFs. In fact, the Release's justification of a floating NAV as necessary to increase transparency and investor awareness is little more than a proposed solution (and a very costly and disruptive one) in search of a problem.

The Release's transparency argument relies on a 2012 survey by Fidelity Investors of its retail investors, which in fact found that the vast majority already understand that securities held by MMFs experience daily fluctuations in value and that MMFs are not guaranteed.²⁵ The Release, however, uses a "glass half empty" approach in dismissing Fidelity's survey, arguing that just because investors understand these facts doesn't mean that they do not expect the government to step in if there is another run on MMFs.²⁶ But, (1) the Fidelity survey involved retail investors – whom the Release proposes to exempt from the purported enlightening effect of its floating NAV requirement, (2) the survey was taken before Fidelity and other MMFs began daily disclosures of prime MMF shadow NAVs, which, presumably, has served to enlighten investors, (3) elsewhere in the Release, the Commission proposes significant new disclosures which, presumably, will have some benefit in further enlightening the small minority of MMF shareholders who may be unaware of the characteristics of MMFs, and (4) in any event, any suggestion that institutional investors are unaware that MMF shares may fluctuate in value is not credible. Numerous institutional investors have submitted comments that demonstrate they are aware fully of the risks of MMFs.²⁷ To the extent that institutional shareholders redeem in a

²⁵ See Letter from Fidelity Investments to SEC (Apr. 26, 2012), available in File No. 4-619 (finding that 81% of Fidelity's retail investors surveyed understood that securities held by MMFs have small daily fluctuations, and 75% of retail customers surveyed understood that MMFs are not guaranteed).

²⁶ Release at 36841 n.61. Moreover, the Release includes retail investors who answered that they were "unsure" when asked their opinion about whether government assistance would be forthcoming in the event of losses at a MMF among those investors who would benefit from the increased transparency of a floating NAV MMF. But expressing an opinion about the likelihood of government action in the event of a crisis is not the same as expressing a misunderstanding of the risks associated with MMFs, which would include the likelihood of support. Regardless of whether retail investors are unsure about the risks of MMFs or the likelihood of MMFs receiving government support in a crisis, a floating NAV for non-retail investors is an entirely unrelated remedy.

²⁷ See, e.g., Letter from Association of Corporate Treasurers to FSOC (Feb. 15, 2013) (available in FSOC-2012-0003) ("[A]s a professional body we flag to our members that even with a constant NAV there is no absolute guarantee that the funds will not suffer a loss."); Letter from Signet Jewelers to FSOC (Feb. 7, 2013) (available in FSOC-2012-0003) ("Although we realize there is a risk of loss when investing, having even small daily principal changes would be of great enough concern so as to potentially preclude us from using money market funds as an

Footnote continued on next page

September 13, 2013

Page 11

crisis, it is because they are well aware that, like almost all other investments, a MMF can lose value, and institutional shareholders would rather redeem than risk their principal. The 2010 amendments to Rule 2a-7 appropriately amended Commission rules to significantly decrease the likelihood that heavy redemptions would endanger a MMF or cause unfair results for shareholders, both by increasing liquidity requirements and credit quality and by giving MMF boards the necessary authorities to address a run (such as the authority to suspend redemptions). As a result, it is difficult to understand what further educational benefit an institutional investor would derive from transacting at a floating NAV that current, and possible enhanced, disclosures would not achieve.

(3) The potential for a “first-mover advantage,” upon which the Commission bases its floating NAV proposal, cannot develop under Rule 2a-7 unless a MMF’s board fails to do its job. While Federated does not believe that further structural reforms are necessary, Alternative Two (with certain modifications) is the only current alternative that would directly and effectively address this concern.

The Release claims a “first-mover advantage” develops when a material deviation from a MMF’s stable \$1.00 per share price occurs, but ignores the protections of current Rule 2a-7 designed to address such deviations.

As discussed above, the Release relies heavily on the notion that a MMF’s stable \$1.00 per share NAV creates an incentive to shareholders to redeem “if a fund’s shadow price deviates far enough from its stable \$1.00 share price”²⁸ The Release further suggests that “if a fund’s shadow price falls below \$1.00 and the fund experiences redemptions, the remaining investors have an incentive to redeem shares to potentially avoid holding shares worth even less, particularly if the fund re-prices its shares below \$1.00.”²⁹ In its Proposed Recommendations to

Footnote continued from previous page
investment vehicle.”); Letter from Texas Municipal League to SEC (May 10, 2012) (available in File No. 4-619) (“The use of money market funds for short-term investments and as a cash management tool is cited as a best practice by the Government Finance Officers Association, because these funds are highly liquid, stable, have a reasonable rate of return, and have minimal risk.”); Letter from 33 Members of Congress to SEC (May 1, 2012), http://www.preservemoneymarketfunds.org/wp-content/uploads/2012/05/Congress_Letter_to_SEC_5-1-12_13359658511.pdf.

²⁸ Release at 36838.

²⁹ *Id.*

September 13, 2013

Page 12

the Commission, the FSOC advocated a similar theory it termed the “first-mover advantage,” which posited that investors have an incentive “to redeem their shares at the first indication of any perceived threat to a MMF’s value or liquidity.”³⁰ The essence of these theories appears to be that MMF’s pricing structure can lead to a run in the event of a change in interest rates or credit risk of the underlying portfolio.

As a threshold matter, it is worth observing that, as the RSFI Study has pointed out, a MMF’s amortized cost valuation “closely tracks” the fund’s shadow price.³¹ In many cases, the two are identical. In the absence of a credit event involving one or more of a MMF’s assets (such as a downgrade or default) which would disrupt this close tracking, there is simply not enough of variation between the amortized cost NAV and the MMF’s shadow price to create the incentive the Commission and FSOC suggest exists. The Commission’s 2010 amendments made structural reforms to MMFs to enhance the credit quality, liquidity, and transparency of MMFs and thereby decrease significantly the likelihood that any significant deviation, short of a major credit event, will occur in the future. Indeed, when faced with heavier-than-normal redemptions during the European debt crisis of summer 2011 and the U.S. debt ceiling impasse, MMFs were able to meet all redemption requests, and shadow prices continued to track closely the \$1.00 per share price.³² No MMF experienced the kind of run about which the Release speculates.

While the 2010 amendments to Rule 2a-7 would not prevent a MMF from breaking the buck if a significant portfolio instrument were marked to zero as a result of a credit event (*i.e.*, if another Lehman-type event were to occur), it is critical to recognize that Rule 2a-7 places a number of detailed remedial obligations on the board of a MMF, in the event such a credit event occurs, which are designed to prevent any first-mover advantage from developing. If a portfolio

³⁰ *Proposed Recommendations Regarding Money Market Mutual Fund Reform*, FSOC, 77 Fed. Reg. 69455 at 69456 (Nov. 19, 2012) (“FSOC Proposed Recommendations”). According to the FSOC Proposed Recommendations, “Because MMFs lack any explicit capacity to absorb losses in their portfolio holdings without depressing the market-based value of their shares, even a small threat to an MMF can start a run. In effect, first movers have a free option to put their investment back to the fund by redeeming shares at the customary stable share price of \$1.00, rather than at a price that reflects the reduced market value of the securities held by the MMF.” *Id.*

³¹ RSFI Study at 83. A fund’s shadow price is based upon market quotations for portfolio securities where they are available and fair valuation of portfolio instruments where market quotations are not available. This is discussed in greater detail in section 5 of this paper.

³² RSFI Study at 34 Table 3. *See also* RSFI Study at 29 Table 2 (finding that under current Rule 2a-7’s requirement that MMFs not exceed a WAM of 60 days the possibility of a MMF breaking a buck due to a change in interest rates is nearly 0%).

September 13, 2013

Page 13

security is downgraded, Rule 2a-7 requires a MMF's board to "reassess promptly whether such security continues to present minimal credit risks and [to] cause the fund to take such action as the board of directors determines is in the best interests of the money market fund and its shareholders" unless the MMF is able to dispose of the security (or it matures) within five days of the event.³³ In the event of a default, the MMF must dispose of the security "as soon as practicable consistent with achieving an orderly disposition" unless the board finds that disposal would not be in the best interest of the MMF.³⁴ Rule 2a-7 also requires prompt notice to the Commission if securities accounting for ½ of 1 percent or more of a MMF's total assets default (other than an immaterial default unrelated to the issuer's financial condition) or the securities become subject to certain events of insolvency.³⁵ In its notice, the board must state the actions the MMF intends to take in response to such event.

Further, a MMF is only permitted to price its shares at \$1.00 using the amortized cost method "so long as the board of directors believes that it fairly reflects the market-based net asset value per share."³⁶ If the board believes any deviation from MMF's amortized cost price per share "may result in material dilution or other unfair results to investors or existing shareholders," the board is required to cause the MMF to take action to eliminate or reduce the effect of the dilution or unfair results.³⁷ Rule 2a-7 provides that in the event that the extent of a MMF's deviation from the mark-to-market NAV exceeds ½ of 1 percent, the board must "promptly consider what action, if any, should be initiated . . ."³⁸ In other words, if a material credit event involving one or more of its portfolio securities occurs, the MMF would be required to cease using amortized cost for the affected portfolio securities and value its shares based on the current NAV (as defined under Commission rules) as other mutual funds do. If immediate recognition of the credit problem causes the MMF to break the buck, a redeeming shareholder would receive the current NAV for each share redeemed, rather than \$1.00. That shareholder would not be receiving the benefit of \$1.00 per share by redeeming before other shareholders. Unless the MMF's board fails to do its job, there is no "first-mover advantage."

³³ 17 C.F.R. § 270.2a-7(c)(7)(i)(A).

³⁴ 17 C.F.R. § 270.2a-7(c)(7)(ii).

³⁵ 17 C.F.R. § 270.2a-7(c)(7)(iii).

³⁶ 17 C.F.R. § 270.2a-7(c)(1).

³⁷ 17 C.F.R. § 270.2a-7(c)(8)(ii)(C). *See also* Letter from Fidelity Investments to FSOC (Feb. 14, 2013) (available in File No. FSOC-2012-0002) (discussing a MMF board's pricing obligations).

³⁸ 17 C.F.R. § 270.2a-7(c)(8)(ii)(B).

September 13, 2013

Page 14

In addition to the above requirements, Rule 22e-3 currently gives a MMF board significant authority to intervene to protect investors, by suspending redemptions and beginning an orderly liquidation if a MMF has broken or is about to break the buck.³⁹ The rule is designed to prevent investor panic and prevent the type of run that could potentially reward first-movers, by assuring that the board has the authority to suspend redemptions in order to treat all investors fairly in a liquidation. The rule addresses the potential for runs regardless of their cause – whether liquidity-driven (such as the 2008 crisis),⁴⁰ credit-driven, or interest-rate driven.⁴¹

Given the multitude of Commission requirements designed to prevent a shareholder run from occurring and to ensure that MMF boards take appropriate action to treat all investors equally and fairly, a floating NAV not only is unnecessary, but would be completely ineffective in promoting the goal of investor fairness – *i.e.*, the elimination of a first-mover advantage. MMF directors have an absolute obligation to act to avoid any material dilution or unfair results to investors and shareholders.

If the Commission does wish to address its concerns about a possible “first-mover” advantage through further reforms, only a temporary redemption limit, rather than a floating NAV, would be required. The Commission could also consider continuing to permit the use of the amortized cost method for all MMFs but provide for types of MMFs, such as MMFs based on size of balance, but this would be subject to resolution of the operational issues of implementing such a product distinction at both the transfer agent and intermediary level.

According to the Release:

Heavy redemptions in money market funds may disproportionately affect slow-moving shareholders because ... redemption data from the 2007–2008 financial crisis show that some institutional investors are likely to redeem from distressed money market funds more quickly than other investors and to redeem a greater

³⁹ 17 C.F.R. § 270.22e-3.

⁴⁰ Of course, in addition to a MMF board’s authority to suspend redemptions in the event of a liquidity-driven crisis, the SEC’s 2010 amendments focused extensively on enhancing the resiliency of MMFs by strengthening the liquidity of MMF portfolios. Rule 2a-7’s liquidity requirements are discussed in detail in Section 15 of this paper.

⁴¹ We applaud the SEC for declining to adopt the FSOC’s proposed recommendation to rescind Rule 22e-3 and recognizing the importance of this board authority. *See* FSOC Proposed Recommendations at 69466.

September 13, 2013

Page 15

percentage of their prime fund holdings. Slower-to-redeem shareholders may be harmed because ... redemptions at a money market fund can concentrate existing losses in the fund or create new losses if the fund must sell assets at a discount. In both cases, redemptions leave the fund's portfolio more likely to lose value, to the detriment of slower-to-redeem investors.⁴²

The Release states: "This likely is because some institutional investors generally have more capital at stake, sophisticated tools, and professional staffs to monitor risk."⁴³

This cannot happen, however, if MMF directors fulfill their obligations, as described above. Contrast, for example, the failure to act in the case of the Reserve Primary Fund with the experience of the Putnam funds.⁴⁴ Moreover, if the Commission believes separating "faster-moving" from "slower-moving" shareholders is an appropriate policy goal, it can work to accomplish this goal without forcing a floating NAV on one group.⁴⁵

While Federated does not believe that further structural reforms to MMFs are necessary, Alternative Two is the only current alternative that would address the policy concerns identified by the Commission, while preserving the utility of MMFs for investors and the short-term financing provided to corporate and governmental issuers. It provides tools MMF directors may use if necessary to protect investors from material dilution and prevent "fire sales" of MMF portfolio holdings if a MMF comes under extraordinary redemption pressure. In a separate letter, Federated is recommending that the Commission make critical modifications to Alternative Two, in order for these additional tools to operate effectively and to minimize their potential impact on shareholders. These modifications include: (a) permitting a liquidity fee or

⁴² Release at 36843. The Release alludes to only the *possibility* that "sophisticated investors took advantage of the opportunity to redeem shares to avoid losses, leaving less sophisticated investors (if co-mingled) to bear the losses." (quoting the RSFI Study at 10.). Neither the Release or the RSFI Study cite any actual case in which sophisticated investors avoided losses at the expense of less sophisticated investors.

⁴³ *Id.* at n. 75. Neither the Release nor the 2009 release cited in support of this statement provide any examples of "sophisticated tools" that investors use to monitor MMF risk nor of any investors who employ staffs to monitor such risks.

⁴⁴ See Letter from Peter E. Madden to SEC (Feb. 13, 2013) (available in SEC file for 2012 Special Studies) (discussing the suspension of redemptions by the Putnam Prime Money Market Fund in September 2008 which permitted the fund to protect customer assets while arranging a sale to Federated).

⁴⁵ See the discussion of "self-selection," at 78 Fed. Reg. 36858.

September 13, 2013

Page 16

temporary suspension of redemptions when a prime MMF's weekly liquid assets have fallen below 10% (rather than 15%) of total assets; (b) reducing the maximum period that redemptions may be suspended to ten calendar days, and subjecting liquidity fees to the same limitation; and (c) permitting a board to implement a liquidity fee or suspend redemptions temporarily *before* the end of the business day, so the board can respond to situations in which unimpeded redemptions are likely to impair a fund's liquidity or the board otherwise determines that such redemption restrictions are in the interest of shareholders. Specifically, a board should be permitted to impose a liquidity fee or temporarily suspend redemptions if (i) it determines there is a substantial risk that a prime MMF's weekly liquid assets will be reduced to less than 10% (the level we propose) of its total assets before the end of a business day or (ii) it determines that such action is appropriate to prevent material dilution or other unfair results to investors and shareholders. Federated believes the Commission should include tax exempt MMFs in the exemption proposed in paragraph (c)(2)(iii). Federated also urges the Commission to make it clear in its release that the purpose of the provision is to protect, and not to penalize, shareholders and that it expects boards to impose liquidity fees or suspensions of redemptions rarely, and only for so long as necessary to protect the interests of shareholders.

In addition, to the extent that the Commission is concerned about the potential for institutional investors to redeem more quickly than retail investors, it could consider other alternatives that would address this issue while retaining the utility of MMFs for all. While we believe it is extremely difficult to define and separate "retail" and "institutional" MMFs, one possibility is to continue to permit the use of the amortized cost method to provide stable value MMFs for all investors, but provide for types of MMFs, such as by limitations on balances, which could be available to investors assumed to be "retail," and thus would permit those investors to separate themselves from investors who require larger balances. Of course, any new type of proposal in this area should be subject to resolution of operational issues related to implementation at both the transfer agent and intermediary level.

September 13, 2013

Page 17

(4) A floating NAV will not produce “mark-to-market” prices for MMF portfolio instruments or for MMF shares. Instead, it will generate time-consuming and costly processes to derive market-based “good faith opinions” of the valuation of MMF portfolio instruments, from which to calculate the required MMF NAVs.

One of the biggest myths, repeatedly and erroneously offered up by advocates of the floating NAV, is that a floating NAV is derived from “mark-to-market” pricing of portfolio instruments and that it therefore provides investors with a “market value” for MMF shares.⁴⁶ This is simply not true. In letters filed with the Commission last fall and with the FSOC earlier this year, we and others pointed out the fallacy of this proposition.⁴⁷ The Release, for the first time, acknowledges it as well. As the Release states,

[T]he vast majority of money market fund portfolio securities are not valued based on market prices obtained through secondary market trading because the secondary markets for most portfolio securities such as commercial paper, repos, and certificates of deposit are not actively traded. Accordingly, most money market fund portfolio securities are valued largely through “mark-to-model” or “matrix pricing” estimates.⁴⁸

⁴⁶ See, e.g., Mary Schapiro, *Statement on Money Market Fund Reform* (Aug. 22, 2012), <http://www.sec.gov/news/press/2012/1012-166htm> (MMFs should “float the NAV and use mark-to-market valuation like every other mutual fund.”); Letter from Timothy F. Geithner to FSOC (Sept. 27, 2012) (Under the FSOC’s proposed recommendations, “MMFs would be required to use mark-to-market valuation to set share prices, like other mutual funds.”)

⁴⁷ Letter from John D. Hawke, Jr. on behalf of Federated to SEC (Nov. 2, 2012) (available in File No. 4-619); Letter from John D. Hawke, Jr. on behalf of Federated to FSOC (Jan. 25, 2013) (available in FSOC-2012-0003). See also Letter from Fisch & Roiter to SEC (Dec. 2, 2011) (available in File No. 4-619) (“Very short-term money market instruments like commercial paper or bank CDs ordinarily lack readily available market prices.”); Letter from Samuel G. Hanson, David S. Scharfstein, and Adi Sunderam to FSOC (December 20, 2012) (available in File No. FSOC-2012-0003) (“[S]econdary markets for commercial paper and other private money market assets such as CDs are highly illiquid. Therefore, the asset prices used to calculate the floating NAV would largely be accounting or model-based estimates, rather than prices based on secondary market transactions with sizable volumes.”).

⁴⁸ Release at 36837. We assume that the Commission’s comments are not intended to encompass the actively traded markets for government securities, or to reflect upon the ability of a MMF to sell such holdings should the MMF find it necessary to do so. Moreover, although there is limited secondary market trading in many money market instruments, MMFs are active buyers in these markets on a daily basis. In fact, such purchases are often used by the pricing vendor to establish the curve from which a model price is derived in the absence of a secondary market transaction.

September 13, 2013

Page 18

But, while the Release states this critical fact, it ignores its significance. The Release fails to analyze or explain the mechanics of matrix pricing, the judgments, estimates and assumptions involved, and how the process – while providing an important benchmark against which the amortized cost valuation of short term instruments can be measured – certainly does not offer the level of precision that carrying a MMF NAV to the fourth decimal point would suggest.⁴⁹

Pricing experts have confirmed to us that only a small percentage of money market instruments actually trade daily in the secondary markets.⁵⁰ While the amortized cost method of valuing MMF portfolios is a simple and accurate means of valuing these types of high-quality, short-term instruments that generally are held to maturity, the effort to arrive at market-based valuations for these types of instruments, which are not actively traded, is time-consuming, complicated, and less exact.

For purposes of “shadow” price comparisons, MMFs typically use independent pricing vendors to obtain “market based” valuations for individual instruments held in the MMF portfolios. Each day, the MMF’s portfolio accountant compiles an electronic file of instruments in the MMF portfolio as of the end of the prior day, to be sent to the MMF’s pricing service for valuation. The file is in an electronic format provided by the pricing vendor and contains fields for information such as CUSIP number, type of instrument, coupon or discount, maturity date, and principal amount. For instruments for which there are no market quotations, the pricing service electronically sorts and groups each instrument or security with a homogenous set of instruments in the market (*e.g.*, in categories such as commercial paper, certificates of deposit, floating rate notes, etc.) and within each category further allocates the instruments to groups based on currency, credit rating, maturity, and other characteristics. The pricing service reviews money market rates in the market for specific types of instruments, programs, currencies and maturity points. From this information, it generates maturity curves for specific categories of instruments and for groups of comparable categories, taking into account factors including instrument type, coupon type, currency, issuer, sector, country of issuer, credit rating and

⁴⁹ See Fair Value Measurement, Accounting Standards Update Topic 820-10-55-3C (Fin. Accounting Standards Bd. May 2011) (“Matrix pricing is a mathematical technique used principally to value some types of financial instruments, such as debt securities, without relying exclusively on quoted prices for the specific securities, but rather by relying on the securities’ relationship to other benchmark quoted securities.”).

⁵⁰ In preparing this analysis of MMF valuation procedures, we consulted a pricing service that provides valuation services to many MMFs and other investors and issuers, including Federated. We greatly appreciate the information and insight they provided, based upon their years of experience in this area.

September 13, 2013

Page 19

prevailing market conditions. Instruments are then assigned to a relevant curve (among several dozen) in order to determine a valuation. Thus, valuations for individual instruments are dependent upon how the pricing vendor groups portfolio instruments, where they are placed on a curve, and a variety of factors, many of which involve estimates and judgments but which do not involve actual trading prices or even actual quotations, except for instruments used for comparison purposes that may have actually traded.⁵¹

Near the end of the day, the pricing service forwards to the MMF's portfolio accountant an electronic file containing the valuations determined for the various instruments requested. Since the MMF inevitably will have made some new purchases in the portfolio during the day, which were not included in the file sent to the pricing service at the beginning of the day, the MMF's portfolio accountant may use its own comparative data and/or access the pricing service's website to obtain a valuation for the new instruments. The portfolio accountant also must generate valuations for any instrument that the pricing service has not valued for other reasons.

After all of the securities and other instruments in a portfolio are assigned values in this manner, the portfolio accountant then derives a NAV per share (accounting for purchases and sales of portfolio instruments, all of the assets and liabilities of the fund, and shareholder purchases and redemptions). These calculations generally are available three to four hours after the pricing vendor's cut off time. Then senior analysts at the MMF review both the NAV provided and valuations of certain individual portfolio instruments for any deviations from certain parameters,⁵² before posting the shadow NAV (which, for those prime MMFs that have been posting daily shadow NAVs, may occur later that evening or the following day).⁵³

⁵¹ Of course, among the most important factors in pricing highly rated money market instruments are the number of days to maturity and the coupon or discount – the same factors that are used in amortized cost valuation.

⁵² As the Commission is aware, MMFs are permitted to use amortized cost *only if* it fairly reflects the market based NAV per share and are required to consider what action to take in the event of a material deviation between the two. 17 C.F.R. § 270.2a-7(c)(1) (permitting a MMF to price its shares at \$1.00 using the amortized cost method only “so long as the board of directors believes that it fairly reflects the market-based net asset value per share.”). In other words, the amortized cost method absolutely *cannot be used* if it does not fairly reflect the “market based” NAV per share.

⁵³ Each MMF board has the ultimate responsibility to assure that valuation methods used are appropriate. Federated views this valuation process as critical to meeting the board's obligation to assure that the stable NAV of its funds, derived from amortized cost valuation, “fairly reflects the market-based net asset value per share,” as required by Rule 2a-7(c)(1). 17 C.F.R. § 270.2a-7(c)(1).

September 13, 2013

Page 20

Appendix One to this paper describes in greater detail the valuation process for a large Federated prime fund. It demonstrates the various steps and time-consuming processes to arrive at an estimated “market-based” valuation. Specifically, for a 3:00 p.m. cut off time from the pricing vendor, the earliest that a reliable “market-based” NAV for a MMF closing at 4 p.m. can be generated is 7:00 p.m. For a fund like Federated’s Prime Obligation Fund, which closes at 5:00 p.m. in order to accommodate end-of-day transactions by investors, the market-based NAV will be available from the fund accountant around 8:00 p.m.⁵⁴

(5) A floating NAV for MMF transactions will place undue reliance upon pricing vendors to MMFs, making them the new rating agencies, with risks and consequences the Commission has failed to consider.

Federated relies upon the care and expertise of the pricing services to produce “market-based” valuations for portfolio instruments and a “market-based” NAV, for comparison to the NAV based on amortized cost valuation. However, in considering whether to force investors, intermediaries, and the MMF industry to incur billions of dollars in retooling costs to convert to “market-based” MMF pricing for transactions – and to require that they push back settlement times for hours, if not overnight, in order to obtain market-based estimates for pricing MMF shares – the Commission must consider the fact that its proposal to require a floating NAV for a large subset of MMFs will *not* produce mark-to-market NAVs for MMFs. Indeed, pricing vendors are completely candid in describing the valuations they produce. For example, one vendor explains that its bid-side “evaluations” (not “prices”) “*represent our good faith opinion* as to what the holder would receive in an orderly transaction (typically in an institutional round lot position) under current market conditions.”⁵⁵

⁵⁴ While we have described the process for arriving at a market-based NAV for prime MMFs, the process for government and tax-free MMFs differs in several ways. Currently, because voluntary daily shadow NAV disclosure has been primarily by prime MMFs, there has been a less time-sensitive process for arriving at shadow NAVs for government and tax exempt funds. This provides more time for the review process (and for challenges of vendor pricing if appropriate) to maintain the integrity of the pricing process. In addition, a larger percentage of securities held in government funds trade daily, although there are still some segments – callable agencies, floating rate agencies, or term repo – that will be more matrix or model priced.

⁵⁵ *Evaluation Services*, Interactive Data Corporation (last visited Sept. 11, 2013), <http://www.interactivedata.com/index.php/productsandservices/content/id/Evaluation+Services> (emphasis added).

September 13, 2013

Page 21

Moreover, the Commission must consider the risks and consequences of placing undue reliance upon the valuations provided by pricing services – essentially making pricing vendors the final arbiters of MMF share valuation, instead of their current and important role as providers of benchmarks for portfolio valuation to enable MMF directors to assure the fairness of MMF share prices arrived at using the amortized cost method. Pricing services will in essence be the “new” rating agencies. The vendors will be given enormous influence and obviously will be enriched substantially in the process, for providing what basically amounts to an opinion on the valuation of a security. MMF companies will be forced to contract with them to provide a service multiple times a day, with no additional discernible benefit to investors. While the methodology used by pricing vendors is inexact – the fact of which they are completely candid in acknowledging – the consequences of the level at which a vendor chooses to establish a price of a holding could have a material impact on the markets and investors, in a manner similar to a ratings change. The number of vendors in the market is not large, which will magnify the influence and potential conflicts that any one vendor may have.

There are substantial operational and technology risks that would be created as well. What would happen, for instance, if there were a systems failure on the part of a vendor, along the lines of the type of breakdowns we have seen recently in other market utilities?⁵⁶ Since there are so few pricing vendors in the market, the impact of an operational failure could be severe. MMFs could be prevented from processing transactions, putting additional stress on the payment and settlement systems. Arguably, the pricing services could be considered systemically significant institutions because of the resulting influence they could have on market functioning – a burden for services providers who do not have the infrastructure or controls to meet the

⁵⁶ See, e.g., John McCrank, *Glitch hits Nasdaq system at center of trading outage*, REUTERS, Sept. 4, 2013, <http://www.reuters.com/article/2013/09/05/us-nasdaq-outage-idUSBRE9830Y920130905>; Michael P. Regan, *Nasdaq Says Flaw Exposed in Data Flood Caused Trade Halt*, BLOOMBERG, Aug. 29, 2013, <http://www.bloomberg.com/news/2013-08-29/nasdaq-says-software-flaw-exposed-in-data-flood-that-led-to-halt.html>; Doris Frankel and Lauren Tara LaCapra, *Goldman losses from options glitch in tens of millions: source*, REUTERS, Aug. 26, 2013, <http://www.reuters.com/article/2013/08/26/us-goldman-options-glitch-idUSBRE97P0S320130826> (“Last Tuesday, an upgrade of Goldman’s internal system affected options on stocks and some exchange-traded funds with symbols beginning with the letters H through L, leading to trades vastly out of line with market prices.”). In fact, according to Nasdaq OMX Group, the first of two recent glitches in the Nasdaq market was caused by “a software flaw in [Nasdaq’s] conduit for disseminating prices” – precisely the same function (although, in Nasdaq’s case, based upon market prices or quotations) that would be provided by pricing services if MMFs were to adopt a floating NAV. Michael P. Regan, *Nasdaq Says Flaw Exposed in Data Flood Caused Trade Halt*, BLOOMBERG, Aug. 29, 2013, <http://www.bloomberg.com/news/2013-08-29/nasdaq-says-software-flaw-exposed-in-data-flood-that-led-to-halt.html>.

September 13, 2013

Page 22

exacting standards being thrust upon them by these proposals. Nowhere in the Release does the Commission even acknowledge these issues, much less attempt to address them.

(6) A floating NAV, which relies upon “market based” estimates, will yield insignificant and irrelevant price fluctuations – essentially “noise” in the estimated valuations.

Day to day, the shadow price of an MMF – however it is determined – deviates from the \$1.00 per share arrived at through amortized cost accounting by only miniscule amounts, if at all. The Investment Company Institute (“ICI”) has produced several studies detailing this point. According to its analysis of MMF prices maintained even *prior* to the 2010 reforms, “Data from a sample of taxable money market funds covering one-quarter of U.S. taxable money market fund assets show that the average per-share market values for prime money market funds varied between \$1.002 and \$0.998 during the decade from 2000 to 2010.”⁵⁷

An analysis of more recent data submitted by the ICI to Congress demonstrates that the remarkable stability of MMF prices has continued under the 2010 reforms:

[U]sing publicly available data from Form N-MFP reports that require money market funds to disclose their underlying mark-to-market share price, without using amortized cost pricing, ICI calculated changes in prime fund share prices on a monthly basis for January 2011 to March 2012. Nearly all (96 percent) of the prime money market funds had an average absolute monthly change in their mark-to-market share prices of 1 basis point [(one hundredth of one penny per share)] or less and all had an average absolute monthly change of less than 2 basis points.⁵⁸

⁵⁷ Letter from ICI to SEC (Feb. 16, 2012) (available in File No. 4-619).

⁵⁸ *Perspectives on Money Market Mutual Fund Reform: Hearing Before the U.S. Senate Committee on Banking, Housing and Urban Affairs*, 112th Cong. at 29-30 (June 21, 2012) (testimony of Paul Schott Stevens, President, Investment Company Institute), http://banking.senate.gov/public/index.cfm?FuseAction=Hearings.Hearing&Hearing_ID=bba4146c-6b7f-47d0-93bc-ebc73189c9c0 (citing the publicly available data from the Form N-MFPs MMFs are required to file each month with the SEC).

September 13, 2013

Page 23

As these data further demonstrate, the stable NAV using amortized cost closely tracks the shadow price (the “floating” value). They are usually identical (even before rounding the NAV to the nearest cent) and only occasionally deviate from one another by plus or minus a few one-hundredths of a cent.⁵⁹ To put this in perspective, a deviation of a hundredth of one percent is equal to ten cents on a thousand dollars worth of MMF shares. Unless the MMF is suddenly liquidated, even that small price deviation is not translated into actual losses or gains, because the underlying portfolio investments mature in short order and are repaid at par, which returns the shadow price to \$1 per share. Due to the very high levels of liquid assets that MMFs are required to hold under amended Rule 2a-7, it is now even less likely that an MMF would need to sell portfolio assets before maturity to raise cash and recover less than par value. The enhanced liquidity requirements of amended Rule 2a-7 further support the economic validity of using amortized cost – they ensure that, absent a credit event, no “first-mover advantage” will materialize.

The RSFI Study confirms this as well. The staff analyzed the distribution of MMF shadow prices between 1994 and 2012 based on data from N-SAR filings. Except for two brief periods, Figure 16 of the Division’s report shows 95% of MMFs continuously maintained 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 \$0.998.⁶⁰ A review of the daily shadow NAV disclosures by major prime MMFs, which began earlier this year, is further evidence of the close tracking of market-based estimates with MMF’s stable \$1.00 per share.

As discussed in Section (4) of this letter, daily “market-based” NAVs are largely based upon “evaluations” and “opinions” of the value of portfolio instruments, not actual trades. Thus, a variation of .0001 or .0002 from \$1.00 per share cannot possibly be viewed as a more “accurate” or “precise” valuation than the stable NAV calculated based on the amortized cost method– which involves no estimates or opinions but, as described below, is based solely on the purchase price, discount or coupon, and maturity of the underlying instruments in the portfolio, and which is 100% accurate for instruments held to maturity.

⁵⁹ *Pricing of U.S. Money Market Funds*, ICI Research Report (Jan. 2011), http://www.ici.org/pdf/ppr_11_mmf_pricing.pdf.

⁶⁰ Division of Risk, Strategy and Financial Innovation, *Response to Questions Posed by Commissioners Aguilar, Paredes, and Gallagher* at 27-28 (Nov. 30, 2012), <http://sec.gov/news/studies/2012/money-market-funds-memo-2012.pdf>.

September 13, 2013

Page 24

(7) To the extent “market-based” evaluations have an informational value for investors – principally to demonstrate that the underlying portfolio instruments and the MMF’s underlying “market-based” NAV fluctuate, however insignificantly, in value – investors already have access to this information and will have even more, if the Commission requires daily shadow NAV disclosure for all MMFs.

Beginning in 2010 with implementation of the Commission’s amendments to Rule 2a-7, and increasing this year with the voluntary daily “shadow” NAV disclosures by a growing list of MMFs, the fact of MMF “market-based” NAV fluctuations has been made evident to any investor who is willing to open his/her/its eyes and read. It is ridiculous to suggest – much less to base a multi-trillion dollar forced restructuring of the MMF industry via amendments to Commission rules upon – the theory that MMF investors should be forced to *transact* at fluctuations of \$.0001 per share in order to understand what they already know. The adoption of a Commission rule based upon this unfounded and incredible theory would be a wholly arbitrary agency action.

If the Commission believes shareholders need more information, it has the authority and expertise to develop additional, carefully crafted disclosure requirements to meet this goal.⁶¹

(8) A floating NAV would impose significant daily operational burdens on MMF users, intermediaries, and MMFs. It will destroy MMFs as a cash management tool and lead to significant and disruptive disintermediation.

The Release does not attempt to resolve the operational problems that a floating NAV will create. At one point, the Release suggests that because MMFs must have the ability to transact at a floating NAV under current Rule 2a-7, MMFs and transfer agents must “already have laid the foundation required to use floating NAVs.”⁶² Although MMF sponsors do have the ability to transact at a floating NAV, doing so on a regular basis will require further retooling of interconnected systems throughout the share transaction process on a scale that has not been required to date. The Release acknowledges that “sub-transfer agents, fund accounting departments, custodians, intermediaries, and others in the distribution chain would need to

⁶¹ We separately will comment on the disclosure proposals in the Release.

⁶² Release at 36870.

September 13, 2013

Page 25

develop and overlay additional controls and procedures on top of existing systems in order to implement a floating NAV on a continual basis.”⁶³

The Release does not discuss the challenges that would be faced by specialized MMF users such as the following:

- corporations using MMFs for operating cash balances and payroll;
- broker-dealers offering brokerage and sweep accounts to optimize returns for their institutional and corporate clients;
- bank trust departments safeguarding funds for individuals, corporations, and other institutions;
- pension plan administrators;
- escrow agents;
- securities and commodity exchanges; or
- state and local governments.

Moreover, the Release significantly underestimates the variety of proprietary software systems used at each level of the MMF transaction process and by each participant in that process that will require updating to accept and accommodate the floating NAV. The challenges that would be faced by specialized users under the Commission’s floating NAV proposal are discussed in more detail in the attached Appendix Two, while the degree to which the systems involved in the MMF transaction process will require overhauling is discussed below.

Investors transact in MMF shares using a variety of different methods. The transaction process for purchases and redemptions of MMF shares requires coordinated interaction between a number of interconnected systems. Moreover, MMF investors and the intermediaries working on their behalf do not have a single method of transacting in MMF shares – rather, investors may place an order through their financial institution and have the institution process a MMF transaction on their behalf, or the investors may contact a MMF’s transfer agent directly to

⁶³ *Id.*

September 13, 2013

Page 26

initiate a transaction; intermediaries may interact with a MMF's trading system directly through automated trading interfaces linked to the MMF's transfer agent system (since MMFs have developed connectivity to enable automated trading with the various recordkeeping systems used by financial institutions in the marketplace) or may do so by telephone, after receiving transaction reports created by their recordkeeping software to aggregate trades. Each system involved in these various transaction flows will have to be reviewed to determine whether a floating NAV can be accommodated, and reconfigured if it cannot. In many cases this would include adding complexity to the transaction flow as described below. This section will describe a typical transaction process by institutional and other large MMF shareholders, and the systems of the intermediaries and other members of the fund complex that serve these institutional clients. As appropriate, this section will incorporate commentary from recent discussions with Federated's clients to demonstrate the impact of the floating NAV on the various systems involved in the MMF transaction process.

The systems used by financial institutions acting as intermediaries would require updating at significant expense to accommodate a floating NAV, and these institutions are stating that they likely will not incur this expense, or would be dependent on their software provider to develop compliant software. Institutional shareholders conduct transactions in MMFs in many different ways. In many cases, shareholders will interface with a specialized platform administered by their financial institution, which serves as the intermediary between the shareholder and the MMF.⁶⁴ Indeed, as Treasury Strategies points out in a recent report, corporate shareholders in particular may use treasury management systems, enterprise resource planning, or other specialized software packages to manage MMF share activity. Many use multiple systems.⁶⁵ In general, these systems are either proprietary systems of the financial institution or are supplied by a software vendor in the marketplace. A single software vendor may offer several different products to its various financial institution clients, and an intermediary may have both proprietary software and software purchased from vendors. Because the systems at the financial institution level vary, their ability to accept a floating NAV, and the openness of the financial institutions themselves to continue to offer floating NAV MMFs, varies:

⁶⁴ Shareholders may also contact the financial institution by telephone to initiate the transaction.

⁶⁵ Letter from Center for Capital Markets Competitiveness to SEC (Aug. 1, 2013) (available in File No. S7-13-03) (enclosing a report by Treasury Strategies titled *Operational Implications of a Floating NAV Across Money Market Fund Industry Key Stakeholders*).

September 13, 2013

Page 27

- The investment management division of one major bank advised Federated that its internal client-facing software is not currently configured to accept anything other than \$1.00 per share; in other words, the \$1.00 NAV is “hard coded” into the bank’s software system. The software is not configured to accept a pricing feed for MMFs to accommodate an NAV other than \$1.00, because it has not been needed up to this point. The bank explained that because the software they use is supplied by their software vendor, the bank would be dependent upon the software vendor to develop upgraded software that is floating NAV-compliant, and that the process would take months of testing in close coordination with the software vendor.
- The capital markets section within the corporate treasury division of one major bank stated that it would remove prime funds with a floating NAV from its proprietary trading portal offered to clients rather than reconfigure the portal to accommodate an intra-day floating NAV and incur the extra expense of obtaining a daily or intra-day pricing feed. Instead, the portal would offer clients government funds only.

Generally speaking, those financial institutions that choose to offer floating NAV MMFs either (1) will need to configure their proprietary platforms to accept a pricing feed and update the client interface to display daily or intraday pricing information, or (2) will be dependent on their software vendor to receive updated and compliant software that will accept a floating NAV, or both. Staff would have to be retrained to accommodate shareholder transaction requests given by telephone, to operate the updated platform, and to address any questions or problems shareholders have with the new platform. The retraining process would be especially burdensome for those intermediaries that offer floating NAV MMFs through a manual process (*e.g.*, giving clients the option to place orders by telephone) rather than exclusively through an online trading system.

Intermediaries are unlikely to take on the expense of developing or purchasing sweeps software that could accommodate a floating NAV, and instead will offer clients alternative investment vehicles. The floating NAV presents a particular challenge to the sweeps programs of financial institutions. Federated has been told by its financial institution clients that the software they use to support sweeps programs is not currently configured to accept a floating NAV. The systems requirements to support a floating NAV would be extensive, and would have to be updated in the following ways:

September 13, 2013

Page 28

- Develop functionality to accept a pricing feed (or multiple feeds) for MMFs and store this information on an intraday basis;
- Develop functionality to register new client NAV policy parameters (for example, instructions to sweep only at or above a given NAV);
- Develop functionality to record Last-in-First-Out and First-in-First-Out liquidation protocol for each client (for example, if a client has two sweep transactions, 100 shares at one price and 100 shares at another price, the sweep software must apply the correct price to each transaction); and
- Develop functionality to track and report gains and losses on each subaccount as a result of sweep transactions.

In addition to systems upgrades, the floating NAV creates challenges for sweeps programs on a systemic level. Depending on the time a particular MMF strikes an intra-day NAV, sweeps transactions submitted overnight would have to remain unsettled for some portion of the day instead of being processed when a MMF first opens. This delay in the time required to settle transactions would increase settlement errors, transaction fails, the size and length of time outstanding that “float,” “due to,” and “due from” balances are tied up in processing of transactions, and counterparty default risk associated with transactions between and among companies. With these extensive systems updates, operational burdens, and additional risks looming, and the availability of alternative products such as FDIC-insured sweeps vehicles, financial institutions have told Federated they will shift to FDIC-insured sweeps vehicles or government MMFs where feasible, or stop offering sweeps altogether.

Each financial institution with proprietary software would need to ensure that its software can interact properly with the retooled systems ultimately developed by the institution’s software vendor to transmit transaction information.⁶⁶ The systems ultimately developed by software vendors would need a number of updates and additional functions to accommodate a floating NAV, including the following:

- Functionality to receive a pricing feed for each MMF with a floating NAV;
- Functionality to store multiple NAVs per day for each MMF;

⁶⁶ Of course, each intermediary and software provider will also be dependent on the ability of pricing services, fund accountants, and fund sponsors to produce and submit the appropriate share price for each MMF as often as an NAV is struck. The complexities associated with striking an intraday NAV for a floating MMF are discussed in a forthcoming letter.

September 13, 2013

Page 29

- Functionality to apply the next NAV to trades timestamped between each strike time;
- Functionality to store a four digit NAV for each MMF as well as a two digit, penny rounded NAV depending on the type of MMF and for shareholder reporting purposes;
- Functionality to deliver and for intermediaries to receive intraday price files through Mutual Fund Profile Services (MFPS);⁶⁷
- Functionality to process intraday price files that are requested by individual shareholders or their intermediary (such as information on position, income, and transaction activity);
- Functionality to store the applicable NAV in each line of a shareholder's transaction history based on the timestamp of the trade; and
- Functionality to support the necessary reporting required by IRS for gains and losses on floating NAV MMF transactions.

As discussed above, many intermediaries will be dependent upon their software vendors to first develop these upgraded systems then to supply compatible products for use by intermediaries to process client transactions.

Transfer Agents and MMF sponsors will also need to develop systems that can accept a continuously floating NAV, and certain functionality currently available to shareholders would simply be lost. Once the intermediary's system has received a MMF transaction request, the intermediary either feeds the transaction information to the MMF's transfer agent directly through an automated process or will generate a transaction report through its recordkeeping software, which the intermediary then submits manually to the MMF via telephone or the MMF's online trading system. Although, as the Release states, each MMF sponsor's transfer agent platform is equipped to handle a temporary floating NAV, each MMF sponsor's system will have to be enhanced to accept a continuously floating NAV. In particular, automated shareholder reports produced by these systems will have to be updated to include pricing information.

Each MMF sponsor will also have to work closely with the MMF's transfer agent to ensure that the transfer agent's system can both accept and remit necessary information. The

⁶⁷ MFPS is a service provided through the National Securities Clearing Corporation. MFPS is the industry's centralized repository where members (funds, broker/dealers and other distribution firms) can automate the exchange of information on securities, participants and distributions (prospectus and operational info, payable date for dividends, capital gains and commissions, fund investment objectives, fee schedules, Blue-Sky details, commission data, breakpoint schedules, etc.).

September 13, 2013

Page 30

transfer agent's system processes and tracks shareholder transaction information (including purchases, redemptions, dividends, and transfers and exchanges of shares), reconciles cash and share activity, disburses commissions owed to brokers or other entities, and creates and stores necessary records on behalf of shareholders (such as confirmations, statements, and required tax reporting forms). Currently, when the transfer agent receives MMF transaction request information it first matches the information received to existing shareholder account information. (This process may involve disaggregating batched information containing multiple orders sent by one institution.) Once the transaction request and the account information are properly linked, the transfer agent uses account-specific instructions regarding how to process the transaction (for example, to which account the funds should be disbursed) to generate a wire transfer in the appropriate amount and with the appropriate instructions. The transfer agent must also send instructions to its own internal accountant to move additional funds into the wire account to fund the order. The transfer agent then wires the funds to the account or the financial institution requesting the redemption. Because the transfer agent knows the transaction price of a MMF at any given time throughout the day (absent a break-the-buck event), the transfer agent can process MMF share transactions frequently throughout the day. Although transaction processing times can vary, the typical turnaround time from receipt by the transfer agent to disbursement of funds is about 1.5 to 2 hours.

Under a floating NAV, the transfer agent's role would have to be expanded, with new steps added to the transaction process, and its systems retooled and reconfigured. Certain functionalities would simply be lost. For example, as systems would no longer be able to assume a \$1.00 per share transaction price, transactions could no longer be processed in the same way they are today. Instead, redemption requests would have to be batched and timed to coincide with the new strike price (which, for a floating NAV MMF, could take three to four hours, or push back settlements overnight), increasing each investor's overall transaction time.⁶⁸ In order to continue processing MMF transactions and provide same-day settlement, the transfer agent's systems would have to be reconfigured to include the same functionalities as those described above for software vendors.⁶⁹ In addition, for each floating NAV MMF transaction, the transfer

⁶⁸ The frequency with which a floating NAV fund would strike a new price throughout the day would depend on many factors, including whether pricing services develop new capabilities to price MMF portfolio securities throughout the day, as well as how much expense a fund and its sponsor would be willing to undertake in order to offer intra-day redemptions.

⁶⁹ Handling requests for redemption of a particular number of shares would also become more complex both for the transfer agent processing the request and the investor. The transfer agent would need to build in a process to calculate the transaction amount for each strike price, and the investor would not know the total redemption amount

Footnote continued on next page

September 13, 2013

Page 31

agent would need to produce and store a confirmation file, and this file will need to be routed to the shareholder directly or to the shareholder's financial institution (whether electronically or in paper form). The transfer agent will also continue to be responsible for the account reconciliation process, which will need to happen on a per transaction basis under a floating NAV (rather than per account basis, as is possible with a stable NAV).⁷⁰ The transfer agent will also be responsible for monitoring the potential tax consequences of MMF transactions discussed below and generating any necessary documentation (including Internal Revenue Service forms and filings). Each of these additional processes will require additional systems upgrades and significant expense.

As discussed in more detail in Appendix Two, a floating NAV will destroy MMFs as a cash management tool for a range of business uses. They will no longer be useful to hold large, short-term cash balances used in the various automated processing systems across a wide variety of businesses and applications. If MMF's no longer provide a business solution for holding short-term cash balances, other vehicles must be used. However, no other vehicle offers the combination of daily liquidity, stable value, low risk with market yield, transparency, and strong regulatory oversight offered by MMFs. We separately comment on these issues in a forthcoming letter addressing the implementation and macroeconomic costs of the proposals.

(9) Using “market-based” estimates to create floating MMF NAVs with insignificant fluctuations will push back settlement times by hours or even overnight, increasing costs, burdens, and risks, including risks in payment systems and markets.

While a stable NAV permits purchases and redemptions to be conducted seamlessly throughout the day, often through automated entries from the ultimate investor via the intermediary's platform, and through automated entries from the intermediary to the MMF's electronic systems, transactions using a floating NAV must be delayed until the next price is struck by a MMF using model portfolio price estimates supplied by an outside pricing vendor.

Footnote continued from previous page
until funds were wired into the investor's account. For many investors, this type of uncertainty would be unacceptable.

⁷⁰ See Letter from Center for Capital Markets Competitiveness to SEC (Aug. 1, 2013) (available in File No. S7-13-03) (enclosing a report by Treasury Strategies titled *Operational Implications of a Floating NAV Across Money Market Fund Industry Key Stakeholders*).

September 13, 2013

Page 32

The striking of a price for a floating NAV MMF will require the same processes MMFs currently use to obtain “market-based” NAVs for purposes of “shadow price” comparisons with the price obtained using amortized cost, as discussed above. However, currently, the “market-based” shadow price is used for benchmarking purposes only; MMF transactions can continue to occur throughout the day at a stable \$1.00 per share NAV, unless there is a substantial deviation between the “market-based” NAV and the stable NAV arrived at using amortized cost. Under a floating NAV, or under a stable NAV rounded from market-based valuations (as the Commission proposes for “retail” and “government” MMFs), transactions must be delayed until the next “market-based” price is struck. As a result, a floating NAV not only will require wide scale systems retooling, as discussed above, but it will push back settlements by hours, perhaps even overnight.

As we discussed in Section (4) of this letter, the process of striking a “market-based” price is time consuming and resource intensive, and generally takes between 3-4 hours from the time the pricing service ends its market research to the time the MMF accountant produces the “market-based” NAV.

For prime institutional MMFs,⁷¹ Alternative One of the proposal permits the continued use of amortized cost accounting to value instruments of 60 days or less (consistent with GAAP)⁷² but prohibits either amortized cost accounting or penny rounding for instruments in portfolio of longer duration; for these it requires the market-based prices calculated as described above. Apart from the operational, tax, accounting, and legal problems created by a floating NAV and discussed in this letter, the proposal creates an absurd situation in which approximately 70% or more of the instruments in a prime institutional MMF – those of 60 days or less in duration – will be valued at amortized cost,⁷³ while approximately 30% will be valued using

⁷¹ Under the proposal, a prime institutional MMF is any registered investment company holding itself out as an MMF that is not operating pursuant to the exemptions of proposed § 270.2a-7(c)(2) (exemption for funds investing primarily in government securities) or (c)(3) (exemption for retail MMFs limiting redemptions by any single shareholder of record to no more than \$1,000,000 in any one business day).

⁷² Release at 36849 (“Money market funds would only be able to use amortized cost valuation to the extent other mutual funds are able to do so—where the fund’s board of directors determines, in good faith, that the fair value of debt securities with remaining maturities of 60 days or less is their amortized cost, unless the particular circumstances warrant otherwise.”); Accounting for Certain Investments in Debt and Equity Securities, Statement of Fin. Accounting Standards No. 115, § 7 (Fin. Accounting Standards Bd. 1993).

⁷³ According to SEC form N-MFP filings compiled by ICI, in June 2012, approximately 72% of prime MMF assets had maturities of less than 60 days. Sean Collins et al., *Money Market Mutual Funds, Risk, and Financial Stability in the Wake of the 2010 Reforms*, 19 ICI Research Perspective 1, Fig. 5 at 11 (Jan. 2013).

September 13, 2013

Page 33

matrix-derived prices, the latter for the sole purpose of creating a NAV fluctuation of, perhaps, hundredths of a cent.⁷⁴ For retail and government MMFs, Alternative One would permit continued use of amortized cost valuation for instruments of less than 60 days duration, but require use of market-based matrix or mark-to-model pricing for the remainder of the portfolio, using penny rounding to achieve the stable NAV⁷⁵ – introducing substantial costs and delays to achieve the same exact result.

The proposals in the Release would introduce the delays, costs, imprecision and burdens associated with the above process into the actual pricing of MMF shares for transaction purposes, creating odd results, new risks, and substantial burdens, all for purpose of showing estimated fluctuations in prices as small as a hundredth of a penny. Even if transaction deadlines are set earlier on each business day, the NAV strike process will push settlements later into the day, creating a potentially destabilizing impact prior to the Fedwire closing and increasing the risk of fails in the payment systems.

Given the settlement delays the floating NAV would create, the product's decreased utility as a cash management vehicle, the increased risk associated with the possibility of technical glitches, and the other reasons discussed in this letter, many MMF users will simply abandon prime MMFs (and may reduce their use of government MMFs as well) for more convenient and useful, stable value products.

⁷⁴ We note here that Federated, in fulfilling its obligations under Rule 2a-7(c)(1) to assure that the stable NAV of its funds, derived from amortized cost valuation, “fairly reflects the market-based net asset value per share,” obtains market-based valuations for all instruments in fund portfolios, except those of 7 days or less duration, which are priced at par.

⁷⁵ Release at 36855 (“Under the proposal, funds taking advantage of the government fund exemption (as well as funds using the retail exemption discussed in the next section) would no longer be permitted to use the amortized cost method of valuation to facilitate a stable NAV, but would continue to be able to use the penny rounding method of pricing.”).

September 13, 2013

Page 34

(10) The Commission’s proposal for MMF pricing at a floating NAV to the fourth decimal point suggests a level of accuracy, or “precision,” that is misleading to investors. An NAV calculated to the fourth decimal point, derived from “good faith opinions” of the “market-based” valuations of MMF portfolio instruments, is nonetheless an estimate and no more accurate than an amortized cost based NAV.

The Commission is well aware of how the “market-based” NAV for MMFs is calculated, as described above, and as described in greater detail in our letter on the amortized cost method. It also is aware of both the importance of this fair valuation process as a benchmark for the stable \$1.00 per share value of MMFs, as well as the differences between this derived price versus a traditional market quote for most other assets. In fact, the Commission has long acknowledged that there is no single “correct” fair value and that “[t]he same security held in the portfolios of different funds can be given different fair value prices at any one time, all of which can be reasonable estimates meeting the statutory standard.”⁷⁶ But, astonishingly, the Release makes the claim that a fluctuating price based on “mark to model” or “matrix pricing,” carried out to the fourth decimal point, has superior informational value compared to amortized cost valuation, because it will “allow funds to reflect gains and losses more precisely.”⁷⁷ In arguing this point, the Release invokes the concept of precision no fewer than 15 times.⁷⁸

⁷⁶ Letter from Fisch & Roiter to SEC at 6 (Dec. 2, 2011) (available in File No. 4-619).

⁷⁷ Release at 36853.

⁷⁸ *Id.* at 36849 (“We also propose to require that all money market funds, other than government and retail money market funds, price their shares using a more *precise* method of rounding.”); *Id.* (“The proposal would require that each money market fund round prices and transact in its shares at the fourth decimal place in the case of a fund with a \$1.00 target share price (i.e., \$1.0000) or an equivalent level of *precision* if a fund prices its shares at a different target level (e.g., a fund with a \$10 target share price would price its shares at \$10.000).”); *Id.* at 36849-50 (“Depending on the degree of fluctuation, this *precision* would increase the observed sensitivity of a fund’s share price to changes in the market values of the fund’s portfolio securities, and should better inform shareholders of the floating nature of the fund’s value.”); *Id.* at 36853 (“We are proposing that money market funds, other than government and retail money market funds, price their shares using a more *precise* method of valuation that would require funds to price and transact in their shares at an NAV that is calculated to the fourth decimal place for shares with a target NAV of one dollar (e.g., \$1.0000).”); *Id.* (“‘Basis point’ rounding is a significantly more *precise* standard than the 1/10th of one percent currently required for most mutual funds.”); *Id.* (“For the reasons discussed below, we believe that our proposal provides the level of *precision* necessary to convey the risks of money market funds to investors.”); *Id.* (“A number of money market funds recently elected to voluntarily report daily shadow NAVs at this level of *precision*.”); *Id.* (“‘Basis point’ rounding should enhance many of the potential advantages of having a floating NAV. It should allow funds to reflect gains and losses more *precisely*. In addition, it should help reduce incentives for investors to redeem shares ahead of other investors when the shadow price is less than \$1.0000

Footnote continued on next page

September 13, 2013

Page 35

The Release's repeated references to the "precision" of its proposed NAV valuation is wholly misleading by suggesting greater accuracy in pricing when, as the Release admits, valuations of many of the instruments in the MMF portfolio are arrived at using estimates. A floating MMF NAV to the fourth decimal point is still an estimate, and one that would appear to involve misleading degrees of "precision." Based upon the good faith opinion of a pricing vendor as to the value of MMF portfolio instruments, it produces "precise" fluctuations for the sake of showing fluctuations, nothing more.

(11) A floating NAV would create accounting uncertainty and substantial daily tax and recordkeeping burdens for users of MMFs and destroy their utility and efficiency. These issues remain unresolved in the Release.

The tax and accounting burdens of a floating NAV stem from the fact that deviations as small as 1/100th of a penny per share will require recordkeeping, must be accounted for, and produce taxable gains and losses. Federated and others have provided extensive analyses of the accounting, tax and other burdens associated with a floating NAV.⁷⁹ While the Release asks for

Footnote continued from previous page

as investors would sell shares at a more *precise* and equitable price than under the current rules."); *Id.* ("At the same time, it should help reduce penalties for investors buying shares when shadow prices are less than \$1.0000. "Basis point" rounding should therefore help stabilize funds in times of market stress by deterring redemptions from investors that would otherwise seek to take advantage of less *precise* pricing to redeem at a higher value than a more *precise* valuation would provide and thus dilute the value of the fund for remaining shareholders."); *Id.* at 36853 n.161 ("Our proposed pricing does not mandate that funds establish a particular share price, but rather amends the *precision* by which a fund prices its shares."); *Id.* at n.163 ("Because floating NAV money market funds, under our proposal, would continue to adhere to rule 2a-7s' risk-limiting conditions and generally seek principal stability, we are proposing that money market funds with a floating NAV value their shares to the nearest 1/100th of 1%, a more *precise* standard than that required of most mutual funds today."); *Id.* at 36904 ("Under our floating NAV proposal we are proposing that a fund would be required to price to the fourth decimal place if they price their shares at one dollar (*e.g.*, \$1.0000), or to an equivalent level of *precision* if the fund uses another price level. We would require such a level of pricing *precision*, in part, to ensure that any fluctuations in a fund's NAV are visible to investors.") (emphases added).

⁷⁹ Letter from Federated Investors to SEC (May 17, 2013) (available in SEC file for 2012 Special Studies); Letter from John D. Hawke, Jr. on behalf of Federated Investors to FSOC (Jan. 25, 2013) (available in File No. FSOC-2012-0003 and SEC File No. for 2012 Special Studies); Letter from John D. Hawke, Jr. on behalf of Federated Investors to SEC (Nov. 2, 2012) (available in File No. 4-619); Letter from John D. Hawke, Jr. on behalf of Federated Investors to SEC (July 17, 2012) (available in File No. 4-619).

September 13, 2013

Page 36

comments on these various problems associated with a floating NAV, it does not solve for them. These issues would need to be completely resolved and the resolutions implemented – not merely discussed – before a floating NAV could be imposed, unless the regulatory goal is to eliminate MMFs.

A. *Tax*

Shareholders currently use MMFs as a temporary holding place for cash without concern that their use of MMFs will trigger tax consequences. So long as the MMF maintains a stable \$1 NAV, there is no risk that a redemption will result in a taxable gain or capital loss that shareholders would need to report on a Form 1099-B. As a result, stable NAV MMFs do not have to report share transactions to their shareholders or to the IRS. The stable NAV further allows a MMF to distribute returns to shareholders as income, which greatly reduces tax and accounting burdens for both retail and institutional investors.⁸⁰ As commenters have explained,⁸¹ the stable NAV also relieves investors from having to consider the timing of purchases and sales of shares of MMFs, as they must with floating NAV MMFs to ensure compliance with the so-called “wash sale rule.”

The Release acknowledges the various tax burdens a floating NAV MMF would place on users. The Release observes that investors in floating NAV MMFs, even those deemed “exempt recipients” under the IRS’s reporting requirements for funds and intermediaries, would face the recordkeeping burden of tracking gains and losses.⁸² The Release also admits that the “tax reporting effects” for any floating NAV investors would be “quite burdensome for money market investors that typically engage in frequent transactions” unless relief from the IRS were forthcoming.⁸³ The Release further acknowledges that “virtually all redemptions” by the many

⁸⁰ Money market funds declare a daily dividend equal to their accrued income each day in order to avoid retained earnings that would cause the fund’s NAV (even determined on an amortized cost basis) to exceed \$1. As a result, each year shareholders pay tax on all of a money market fund’s annual taxable income at ordinary income tax rates.

⁸¹ Letter from Vanguard to SEC (June 4, 2012); Letter from Allegheny Conference and Greater Pittsburgh Chamber to SEC (Apr. 24, 2012); Letter from ICI to SEC (Jan. 10, 2011); Letter from Voyager Asset Management to SEC (Sept. 8, 2009). *See also* Money Market Working Group, Investment Company Institute, *Report of the Money Market Working Group* at 107-08 (Mar. 17, 2009), http://www.ici.org/pdf/ppr_09_mmwg.pdf.

⁸² Release at 36868.

⁸³ *Id.* Regarding the potential for relief from burdensome information reporting, the Release states, “We also understand that the Treasury Department and the IRS are considering alternatives for modifying forms and guidance

Footnote continued on next page

September 13, 2013

Page 37

floating NAV MMF investors who automatically reinvest their dividends would trigger wash sale rules, as all redemptions “would be within 30 days of a dividend reinvestment (*i.e.*, purchase).”⁸⁴

After the proposed rule’s release, the IRS issued a proposed revenue procedure addressing the tax *burden* associated with the wash sale rule specifically. The proposed revenue procedure would provide *de minimis* relief from the wash sale rule for losses not exceeding one half of one percent (0.5%) of the taxpayer’s basis in a given share.⁸⁵ But this proposed IRS relief, which has not yet been finalized, does not relieve shareholders of the tax *compliance* costs associated with the wash sale rule. As a result, MMFs or their transfer agents will still incur substantial costs to develop systems to monitor for and identify potential wash sale transactions, to compare those transactions to the *de minimis* relief, and either to comply with the wash sale rule if the transaction does not qualify for relief or to adjust shareholder basis when it does.

Moreover, unless further relief is forthcoming, investors in floating NAV MMFs also will need to track the amount and timing of all purchases and sales, capital gains and losses (including whether gains and losses are short-term or long-term), and share cost basis to ensure compliance with tax reporting rules. Investors already face these burdens in connection with investments in long-term mutual funds, but most investors do not trade in and out of long-term mutual funds with the same frequency as many do with MMFs. Moreover, as the ICI has explained, often the investments in long-term mutual funds are made within tax-advantaged accounts (*e.g.*, 401(k) plans), where such issues do not arise.⁸⁶ Thus, if certain MMFs had a floating NAV, and all share sales became tax-reportable events, the result would be to magnify greatly the tax and recordkeeping burdens of investors who use their MMFs for daily cash

Footnote continued from previous page

(1) to include net information reporting by the funds of realized gains and losses for sales of all mutual fund shares; and (2) to allow summary income tax reporting by shareholders.” *Id.*

⁸⁴ *Id.* at 36869. Regarding the potential for relief from the wash sale rule, the Release states “We understand that the Treasury Department and IRS are actively considering administrative relief under which redemptions of floating NAV money market fund shares that generate losses below a *de minimis* threshold would not be subject to the wash sale rules. We recognize, however, that money market funds would still incur operational costs to establish systems with the capability of identifying wash sale transactions, assessing whether they meet the *de minimis* criterion, and adjusting shareholder basis as needed when they do not.” *Id.*

⁸⁵ Proposed Revenue Procedure, *Application of Wash Sale Rules to Money Market Fund Shares*, IRS Notice 2013-48 (July 2, 2013), <http://www.irs.gov/pub/irs-drop/n-13-48.pdf>.

⁸⁶ Letter from ICI to SEC (Jan. 10, 2011) (available in File No. 4-619).

September 13, 2013

Page 38

management purposes, all for the purpose of tracking deviations that may amount to as little as 1/100th of a penny per share.⁸⁷ MMFs or their transfer agents will also have to develop systems to track gains and losses accrued as a result of shareholder redemptions.

B. Accounting

As the Release explains, with a stable \$1.00 NAV, MMFs shares currently qualify as “cash equivalents” on a company’s balance sheet under U.S. generally accepted accounting principles (GAAP) (except in the rare instances where a MMF breaks a dollar).⁸⁸ “Cash equivalents,” the ICI explains, “are carried at either face value (e.g., bank deposits and money market fund shares) or amortized cost (e.g., Treasury bills and commercial paper) on a firm’s balance sheet, and as such are not marked to market.”⁸⁹ As a result, investors do not need to recognize gains or losses for financial accounting purposes, as they would if the shares were classified as available-for-sale and valued at “fair value.” This accounting benefit is critical to corporate shareholders using MMFs for daily cash management. There is significant uncertainty as to whether a shareholder’s investment in a floating NAV MMF would continue to qualify as a cash equivalent, or whether it would need to be reclassified.

Of all the tax, accounting, and other burdens discussed in the Release, the only issue the Release attempts to address is how a floating NAV would impact the current GAAP treatment of MMFs.⁹⁰ But the Release’s statement hardly solves the issue. The Release states, “We believe

⁸⁷ Multiple commenters warned that a floating NAV would cause each MMF sale a tax-reportable event. Letter from Donald Brundrett to SEC (Mar. 24, 2012); Letter from Indiana Chamber to SEC (Mar. 20, 2012); Letter from SunGard Global Network to SEC (Mar. 16, 2012); Letter from Washington State Treasurer to SEC (Nov. 15, 2011); Letter from Financial Services Institute to SEC (Jan. 10, 2011); Letter from FSC Securities Corporation to SEC (Jan. 10, 2011); Letter from Fidelity Investments to SEC (Jan. 10, 2011); Letter from Wells Fargo Funds Management to SEC (Jan. 10, 2011); Letter from Treasury Strategies to SEC (Jan. 10, 2011); Letter from Royal Alliance Associates to SEC (Jan. 7, 2011); Letter from Letter from SagePoint Financial to SEC (Jan. 7, 2011). *See also* PWG Report at 21 (noting the “loss of accounting convenience and tax efficiencies” resulting from the move to a floating NAV).

⁸⁸ *See* Statement of Cash Flows, Statement on Fin. Accounting Standards No. 95 (Fin. Accounting Standards Bd. 1987) (“[C]ash equivalents are short-term, highly liquid investments that are both: readily convertible to known amounts of cash and so near their maturity that they present insignificant risk of changes in value because of changes in interest rates Examples of items commonly considered to be cash equivalents are Treasury bills, commercial paper, money market funds, and federal funds sold (for an enterprise with banking operations).”).

⁸⁹ Money Market Working Group, Investment Company Institute, *Report of the Money Market Working Group* at 27 (Mar. 17, 2009), http://www.ici.org/pdf/ppr_09_mmwg.pdf.

⁹⁰ Release at 36869.

September 13, 2013

Page 39

the adoption of floating NAV alone would not preclude shareholders from classifying their investments in [MMFs] as cash equivalents because fluctuations in the amount of cash received upon redemption would likely be insignificant and would be consistent with the [GAAP] concept of a ‘known’ amount of cash.”⁹¹ This statement, unfortunately, does not provide the certainty private users of MMFs would need to continue investing.⁹² Interestingly, while the Release in this context relies on the “insignificance” of fluctuations in the floating NAV, the Release, at the same time, emphasizes the importance of adopting a floating NAV to the fourth decimal point in order to “mak[e] gains and losses a more regular and observable occurrence” in MMFs.⁹³ In other words, the central purpose of the floating NAV proposal is to *create* gains and losses. It is indeed strange for the Commission to then state that, as an accounting matter, the fact of these gains and losses should be ignored. Unless the Commission can resolve these conflicting views regarding the accounting treatment of floating NAV MMF shares, and clarify to shareholders that floating NAV MMF shares will continue to be considered cash equivalents, companies may be forced to classify shares as available-for-sale securities and thereby devote resources to monitoring and recording any minute gains or losses on those shares.

Regardless of how floating NAV shares are classified, any realized gains and losses on share transactions would be reported on a company’s income statement. Unrealized gains and losses currently would be reflected as an adjustment to the company’s equity on the balance sheet. The Financial Accounting Standards Board (“FASB”) has proposed, however, to include unrealized gains and losses on mutual fund shares in a company’s income statement. If the FASB adopts this proposal, fluctuations in a MMF’s NAV could affect a company’s reported earnings during the period of the fluctuations. When the fund’s NAV reverts to \$1.00 per share (as it should), this would have the opposite effect on earnings during a later period. Companies invested in floating NAV MMFs will incur the additional accounting and reporting burden and volatility in earnings of including MMF gains and losses in the income statement. On a practical level, shareholders simply may shift funds away from prime MMFs into government MMFs, or away from MMFs entirely, to avoid this uncertain accounting treatment.

⁹¹ *Id.*

⁹² Although the Commission has the authority to set GAAP standards by regulation, it has historically declined to do so, instead preferring to rely on the Financial Accounting Standards Board and related entities to set standards. In this case, if the Commission decides to require certain MMFs to adopt a floating NAV, the Commission should provide the accounting certainty investors need by declaring positively that investments in such funds will continue to constitute “cash equivalents.”

⁹³ Release at 36851.

September 13, 2013

Page 40

(12) A floating NAV would altogether prevent certain investors who are subject to statutory prohibitions and investment restrictions from using prime MMFs.

The investments of many corporate, institutional, and state and local government shareholders of MMFs are predicated on a large body of laws, regulations, investment policies, and contractual requirements that authorize use of MMFs for cash balances based on the assumption that MMFs will maintain a stable value under normal market conditions. In particular, the investment of public funds in registered investment companies such as MMFs frequently is constrained by state law to only those that seek to maintain a stable NAV.⁹⁴ State and local treasurers subject to these statutory constraints have already written to the Commission

⁹⁴ See, e.g., Ariz. Rev. Stat. § 35-313 (“The state treasurer shall invest and reinvest trust and treasury monies in any of the following items: . . . 8. Securities of or any other interests in any open-end or closed-end management type investment company or investment trust . . . registered under the investment company act of 1940 For any treasurer investment pool that seeks to maintain a constant share price, both of the following apply: (a) The investment company or investment trust takes delivery of the collateral for any repurchase agreement either directly or through an authorized custodian. (b) The investment policy of the investment company or investment trust includes seeking to maintain a constant share price.”); Colo. Rev. Stat. § 24-75-601.1 (“It is lawful to invest public funds in any of the following securities: . . . (k) Any money market fund that is registered as an investment company under the federal “Investment Company Act of 1940”, as amended, if . . . [t]he investment policies of the fund include seeking to maintain a constant share price”); Del. Code Ann. tit. 31, § 4013 (“In addition to its other powers, [the Delaware State Housing Authority] is hereby granted, has and may exercise all powers necessary or appropriate to carry out and effectuate its corporate purposes, including, without limitation, the following . . . (17) To invest any funds not needed for immediate use or disbursement including any funds held in reserve in the following . . . 1. Shares of any investment company that . . . [m]aintains a constant net asset value per share”); Me. Rev. Stat. tit. 5, § 135 (“When there is excess money in the State Treasury that is not needed to meet current obligations, the Treasurer of State may invest . . . those amounts in . . . so-called ‘no-load’ shares of any investment company registered under the federal Investment Company Act of 1940, as amended, that complies with Rule 2a-7 guidelines and maintains a constant share price.”); Tex. Gov’t. Code § 2256.014 (“A no-load money market mutual fund is an authorized investment under this subchapter if the mutual fund . . . includes in its investment objectives the maintenance of a stable net asset value of \$1 for each share.”); Letter from County Commissioners Association of Ohio to FSOC (Dec. 21, 2012) (available in File No. FSOC–2012–0003) (“County governments in Ohio operate under legal constraints or other policies that limit them from investing in instruments without a stable value. If money market funds are required to float with their NAVs, many counties in Ohio would be forced to use alternative funds that are less regulated, less secure, and less liquid”); Letter from Metropolitan Mayors Caucus to SEC (Mar. 28, 2012) (available in File No, 4.619) (“Many governments are required by statute to invest in financial products which bear less risk and have stable values. Money market funds are the investments used to ensure compliance with these state and local laws.”).

September 13, 2013

Page 41

and others to state that they will not be able to invest in floating NAV MMFs.⁹⁵ Moreover, fiduciary laws in many jurisdictions designate certain types of assets as permitted investments for trusts and certain other fiduciary accounts, and MMFs have been recognized expressly as permitted fiduciary investments in many states.⁹⁶ Fiduciaries subject to these laws would need to determine whether a floating NAV MMF would continue to constitute a permissible investment, and may shift to alternative investment products to avoid the potential legal liability of placing client funds in impermissible investments.

As the Commission is aware, MMFs are also designated as eligible investments in thousands of trust indentures, investment agreements, board-approved policies, and other legal documents. For example, bank trust departments have told Federated they cannot and will not use floating NAV MMFs for corporate trust purposes, where requirements for stable value investments are embedded throughout customer agreements. In addition, they have advised that trust clients give strict guidelines as to what investments are permissible and that in many cases, they would need to review every trust agreement individually to determine whether to continue to invest client funds in floating NAV MMFs. There is no guarantee that trust departments and others affected would necessarily decide to incur this burden and expense in order to invest cash balances in a product in which the stability of their clients' principal may be at risk. There is no guarantee that institutional and other investors subject to investment policies would conclude that floating NAV MMFs constitute an acceptable investment.⁹⁷ In all likelihood, fiduciaries will simply shift funds into alternative investment products which may not offer the combination of stable value, low risk, transparency, and regulatory oversight offered by MMFs. Further, many businesses and other institutions have entered into debt covenants and escrow and other agreements that require collateral to be invested in stable value products. These institutions also would have to review these covenants and agreements to consider the effect of the floating NAV.

⁹⁵ Letter from County Commissioners Association of Ohio to FSOC (Dec. 21, 2012) (available in File No. FSOC-2012-0003); Letter from the Texas Municipal League to SEC (Jan. 21, 2011) (available in File No. 4-619); Letter from 12 State and Local Entities to SEC (Jan. 10, 2011) (available in File No. 4-619); Letter from the Senior Director, of Finance for the Port of Houston Authority (Jan. 6, 2011) (available in File No. 4-619).

⁹⁶ *See, e.g.*, Ala. Code § 19-4A-3; Cal. Prob. Code § 9730; Fla. Stat. Ann § 736.0816.

⁹⁷ Letter from Association for Financial Professionals and 13 other organizations to SEC (Apr. 4, 2012) (available in File No. 4-619) ("For purchasers of MMFs, the return of principal is a much greater driver of the investment decision than return on principal. For a large number of institutional investors, the potential of principal loss would preclude investing in floating NAV MMFs. . . . In many instances, MMFs are the vehicle that most closely match the risk/return profile sought for surplus operating cash, as specified by a written investment policy. Changing to a floating NAV would significantly change the risk/return profile of MMFs.").

September 13, 2013

Page 42

In all likelihood, these agreements would have to be renegotiated and modified at significant expense to the parties, assuming both parties agree to modification. Many institutions likely will decide to forego that expense by shifting to alternative stable value products.

The Release candidly acknowledges the fact that many MMF shareholders are subject to legal and other restrictions that would prevent them from investing in floating NAV MMFs.⁹⁸ But instead of providing clarity on these issues, or attempting to tailor its proposal to meet the needs of MMF investors, the Release simply assumes that the two-year transition period would provide these shareholders sufficient time to “modify their investment guidelines or seek changes to any statutory or regulatory constraints to which they are subject to permit them to invest in a floating NAV money market fund”⁹⁹ At the same time, the Release candidly admits that where investors are subject to statutory or regulatory guidelines restricting investment options,

We anticipate monies would flow out of prime money market funds and into government money market funds or alternate investment vehicles. This would result in a contraction in the prime money market fund industry, thereby reducing the type and amount of money market fund investments available to investors and potentially harming the ability of money market funds to compete in several respects affected by our proposal.¹⁰⁰

Here, the Release has raised a significant issue that will affect a vast number of MMF users, but has failed to address it. In fact, for those investors subject to statutory and regulatory requirements, the Release appears to assume that a shift to government MMFs (which, as we have separately written, would raise costs for private funding and drive down yields in government MMFs) or other investment vehicles (primarily banks, which, as we have separately written, will increase systemic risk) would be a satisfactory outcome. There is no justification for burdening these investors with the costs of changing thousands of statutes, regulations, investment policies, and contractual requirements simply to continue to be able to use stable value prime MMFs, as they have for decades, or, in the more likely case, to justify forcing a

⁹⁸ Release at 36915-16 (“We also understand that some institutional investors currently are prohibited by board-approved guidelines or internal policies from investing certain assets in money market funds that do not have a stable value per share. Other investors, including state and local governments, may be subject to statutory or regulatory requirements that permit them to invest certain assets only in funds that seek to maintain a stable value per share.”).

⁹⁹ *Id.* at 36877.

¹⁰⁰ *Id.* at 36916.

September 13, 2013

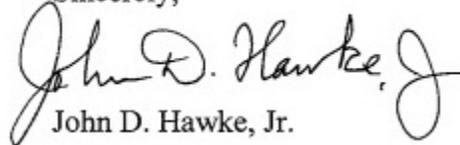
Page 43

wholesale shift of assets from prime MMFs into government MMFs or alternative investment vehicles.

Conclusion

We appreciate the opportunity to provide comments on the Release. A floating NAV would create severe operational problems for intermediaries, members of a MMF complex, and investors, would push back settlement times by hours or overnight, would create burdensome tax and accounting issues for shareholders, and would result in the departure of institutional and state and local government investors from prime MMFs. The adoption of a floating NAV will result in a significant shrinkage in MMFs in favor of riskier and less transparent investment vehicles. We urge the Commission not to adopt a floating NAV for any MMFs. If the Commission chooses to adopt some form of the proposals, a modified version of Alternative Two, as Federated is separately proposing, could work to protect shareholders from unfair results.

Sincerely,

A handwritten signature in cursive script that reads "John D. Hawke, Jr." The signature is written in black ink and is positioned above the printed name.

John D. Hawke, Jr.

Appendix One

Process to Strike a Daily Shadow NAV Per Share for a Typical Prime Fund

Appendix One

Process to Strike a Daily Shadow NAV Per Share for a Typical Prime Fund¹

The procedures used by Federated to reach a “market-based” shadow NAV per share for one of its largest prime funds, the Prime Obligations Fund (“POF”),² are summarized below. Like many other fund sponsors, Federated now offers a daily shadow NAV for POF (as well as four other prime funds) in an effort to provide additional transparency to shareholders.³

Time	Action	Further Explanation
7 a.m.	The Portfolio Accountant for POF (which also serves as custodian for POF and 35 other Federated MMFs) sends an electronic file listing POF’s portfolio instruments to the independent Pricing Service retained by the Portfolio Accountant for Federated’s MMFs via electronic feed.	The file contains CUSIP numbers and certain key characteristics for all instruments held as of the end of the prior day in the portfolio of all Federated MMFs for which the Portfolio Accountant and Pricing Service perform portfolio valuation and accounting services. As of July 31, 2013, the portfolio of POF contained more than 325 individual instruments, with a total asset value of \$43.2 billion. In addition to POF, the file will contain the portfolio instruments held in 35 other Federated MMFs. The file is in an electronic format, specified by the Pricing Service. Fields for each CUSIP include information such as type of instrument (e.g., commercial paper, CD), interest rate, coupon, maturity date, principal amount.
Upon receipt, during morning hours.	Portfolio instruments listed in the files arriving at the Pricing Service are electronically assigned to groupings, based upon key characteristics.	Instruments are grouped into categories (e.g., commercial paper, CDs, etc.) for evaluation and, within categories may be further divided into maturity ranges. Instruments such as commercial paper and certificates of deposit are evaluated using a matrix-based approach: They are allocated to groups based on characteristics including security type, currency, issuer, sector, and credit rating.
During the day.	Since the file delivered by the Portfolio Accountant to the Pricing Service for evaluations contains only those instruments in Federated’s MMF portfolios as of the	The Pricing Service will provide evaluations at the end of the day only for those instruments listed in the 7 a.m. file. The Portfolio Accountant will need to obtain evaluations for

September 13, 2013

Page 2

	end of the prior business day, the Portfolio Accountant during the day must track portfolio changes in each of Federated's funds.	any portfolio instruments purchased by POF (and by other Federated MMFs) during the course of the day.
During the day.	During the day, evaluators at the Pricing Service contact market sources to obtain relevant market data to create various curves based on rating, structure, and maturity. These market sources may include various financial institution issuers (to assess market rates) and information available on various websites.	The Pricing Service provides evaluation services to numerous other fixed income fund advisers. Its evaluators specialize in a particular sector (such as the money market sector) and may sub-specialize in specific issuer types (such as financial issuers). The role of each evaluator is to maintain and update the appropriate curve for a particular grouping of instruments. During the day, scales are derived for the various instruments, based on market data, taking into account time to maturity.
12 p.m.	Evaluators take a snapshot of the 12:00 p.m. rates to craft a curve.	Instruments may be placed on the appropriate curve for valuation as of that time.
12-3 p.m.	Evaluators will make adjustments if warranted on a per issue/issuer basis up until 3 p.m., at which time they begin their pricing process.	
3 p.m.	Cut-off time for the Pricing Service's collection of market data.	The Pricing Service works to a 3 p.m. "close" for building market data into its valuations.
3-4 p.m.	Between 3 and 4 p.m., the Pricing Service builds out the valuations for individual instruments, based upon where the instrument falls on the curve for that grouping of instruments, developed during the day.	A bid evaluation is calculated using a derived yield. Inputs may include maturity date, issue date, current commercial paper rate, settlement date, and (for coupon bearing instruments) the coupon rate. Because many instruments in POF (and other prime MMFs) do not trade daily, and there are no available market quotations, this process has been described by those involved to be "as much art as science."

September 13, 2013

Page 3

4 p.m.	The Pricing Service begins to release evaluations, and pricing files are transmitted via electronic feed to MMF accountants.	For each instrument, the file delivered to the MMF accountant contains a unique identifier, the evaluation, and the yield. The evaluations produced are not described as prices or quotations, but as “evaluations.” The Pricing Service describes its bid-side evaluations as representing “our good faith opinion as to what the holder would receive in an orderly transaction (typically in an institutional round lot position) under current market conditions.”
4:40 p.m.	The Portfolio Accountant receives the Pricing Service’s evaluations. Using each instrument’s unique CUSIP, the Portfolio Accountant, is able to “map” the evaluations for each instrument back into the appropriate fund portfolio, including POF’s portfolio.	

<p>5 - 5:40 p.m.</p>	<p>The Portfolio Accountant begins its review and validation of the evaluations, including the following actions:</p> <ul style="list-style-type: none"> • Determining whether evaluations of any individual instruments are outside the Portfolio Accountant’s established tolerance levels. • Providing evaluations for instruments added to the portfolio during that day. • Providing evaluations for other instruments for which the Pricing Service has not returned an evaluation (because the Pricing Service did not have a valuation for the instrument). 	<p>For funds with a 4 p.m. close, the Portfolio Accountant can begin its review and validation by 5 p.m. However, since POF has a 5 p.m. close in order to accommodate investor redemptions up to that time, the Portfolio Accountant cannot begin the NAV calculation process until approximately 5:40 pm. Note that (1) portfolio purchases in the MMF will result in new instruments that must be valued (since the file received from the Pricing Service will contain only those instruments held by the funds at the close of the prior business day), (2) portfolio trades also will affect the total assets of the fund and its valuation, and (3) shareholder purchases and redemptions, which may occur up until the close of trading, will affect the number of shares that must be divided into the fund assets in order to calculate a per share NAV for POF.</p> <p>If an evaluation does not appear to be reasonable in the judgment of the reviewer at the Portfolio Accountant, the reviewer may consult a secondary pricing service, flag the issue with Federated’s internal treasury team, and may (after consulting with Federated) submit a formal challenge through the Pricing Service’s website.</p> <p>If the Pricing Service has not provided an evaluation for a particular instrument (for example, if an instrument is newly issued), the Portfolio Accountant may return to the Pricing Service to request coverage or return to Federated’s internal treasury team for guidance.</p> <p>To provide evaluations for instruments added to POF’s portfolio that day, the Portfolio Accountant will access the Pricing Service’s web-based platform or another application to obtain the missing evaluations.</p>
--------------------------	--	---

September 13, 2013

Page 5

<p>After 5 p.m.</p>	<p>The Portfolio Accountant receives final information on the day's shareholder activity for each fund from Federated's transfer agent, via electronic feed.</p>	<p>The Portfolio Accountant needs this information for the per share NAV calculation process.</p>
<p>7-8 p.m.</p>	<p>Once the Portfolio Accountant is satisfied with the evaluation data received, it calculates a market value for POF. It calculates an NAV per share by valuating the assets of the fund as a whole, subtracting its liabilities, and dividing the balance by the number of shares outstanding.</p>	
<p>7-8 p.m.</p>	<p>The Portfolio Accountant strikes a shadow NAV per share for POF.</p>	<p>The Portfolio Accountant's review and validation process takes approximately 2-3 hours from the time the file is received from the Pricing Service to the time the NAV is struck.</p>
<p>Next Day</p>		
<p>10-11 a.m.</p>	<p>The Portfolio Accountant provides the shadow NAV price per share to Federated via electronic feed. Currently, because Federated is posting the shadow NAV on a next day basis, the information is received at Federated early the next morning.</p> <p>The information is reviewed and validated by Federated's internal treasury and portfolio management teams before it is posted. This process takes approximately one hour.</p>	<p>The Portfolio Accountant currently offers to feed MMF websites on a same-day basis between 8 and 9 p.m. (Federated could receive the feed and begin its own review work at this time, but currently conducts its review the next morning.) Federated assesses the valuation against its own tolerance levels. Note that Federated is responsible for the valuation ultimately published for investors, as well as responsible for monitoring the "market based" NAV for purposes of assessing the stable \$1.00 NAV for POF.</p>
<p>12 p.m.</p>	<p>The shadow NAV price per share for POF is posted on Federated's website.</p>	

September 13, 2013

Page 6

¹ This Appendix summarizes information obtained through calls with the Portfolio Accountant for Federated's POF and the Pricing Service for POF to discuss the process by which the shadow NAV of a MMF is reached. The Portfolio Accountant also serves as POF's custodian, and safekeeps the fund's assets and performs the day-to-day operations of the fund. In its role as the Portfolio Accountant, it records purchases and sales of fund holdings, collects valuation information for each instrument, and calculates the fund's NAV per share through mark-to-model valuation. The Pricing Vendor supplies mark-to-model valuation information to the Portfolio Accountant on a per instrument basis to facilitate its calculations.

² POF's portfolio of holdings is typical of a large prime fund. It holds primarily short-term, high-quality, fixed-income securities issued by banks, corporations and the U.S. government, rated in the highest short-term category or of comparable quality. Detailed holdings and other information, performance data, and, more recently, daily shadow NAV prices for POF are available on Federated's website. See *Federated Prime Obligations Fund*, Federated Investors (Sept. 12, 2013), <http://www.federatedinvestors.com/FII/mutualfunds/details/portfolioCharacteristics.do?fundshareid=7&basketid=96>.

³ POF, of course, is still priced for trading purposes using the amortized cost method of accounting. In addition to the shadow NAV calculated as described in this section, the fund accountant also calculates and records the amortized cost valuation of the fund to four decimal places on a daily basis to provide an internal check on the fund's published price. Federated conducts checks on the prices of its other MMFs that are obtained through the use of amortized cost by determining the shadow NAV for those funds on a weekly or biweekly basis, depending on the characteristics of the fund.

Appendix Two

MMF Uses Impacted by the Floating NAV Requirement

Appendix Two

MMF Uses Impacted by the Floating NAV Requirement

The MMF business developed during a period in which a wide range of businesses moved from archaic manual systems to automated systems for processing the posting and settlement of various types of transactions. As a result, use of stable value MMFs to hold short-term liquidity was incorporated into many of the accounting systems and the automated interfaces used in these systems. Examples, which are discussed in more detail below, include trust accounting systems at bank trust departments, corporate payroll processing, corporate and institutional operating cash balances, federal, state and local government cash balances, municipal bond trustee cash management systems, consumer receivable securitization cash processing, escrow processing, custody cash balances and investment manager cash balances, 401(k) and 403(b) employee benefit plan processing, broker-dealer and futures dealer customer cash balances, and cash management type accounts at banks and broker-dealers.

The systems changes that have been implemented in many different businesses over the past four decades have greatly reduced (i) the time required to post and settle transactions, (ii) the personnel required to post and settle transactions (and thus the overhead costs associated with those functions), (iii) the errors associated with posting and settling those transactions, (iv) the “fails” involved in settling those transactions, (v) the size and length of time outstanding of the “float,” “due to,” and “due from” balances tied up in processing of transactions, and (vi) the counterparty default risk associated with transactions between and among companies. These changes have had the net result over the past four decades of reducing risk and increasing the efficiency of many business activities and greatly reducing the amount of funding required for businesses to conduct transaction processing.

Many of these systems have as a key element the use of MMFs to hold short-term liquidity in connection with settlement of the transactions. The features of MMFs that are ideal for holding temporary balances in these systems include (1) stable \$1 per-share value during the time the transaction is being processed to allow certainty during the day of the exact dollar amounts that are being processed between different counterparty accounting systems so that the amount due and the amount paid do not diverge even by a few cents during the time in which the transaction is being processed, (2) same-day settlement capability (T+0 processing) on a frequent intra-day basis with short turnaround times between placement and settlement of transactions at times corresponding to investor payment needs, which is possible only because of the use of amortized cost by MMFs, (3) high credit quality and underlying portfolio issuer diversification which reduces risk of insolvency during the time the transaction is being processed, and (4) operation within a highly-automated secure computer environment that allows for 24/7 no downtime interfaces with accounting and data processing systems of all parties to the transactions.

September 13, 2013

Page 2

The use of amortized cost and the resulting stable NAV are crucial features of MMFs that allow them to work with automated processing systems. Amortized cost allows the use of a stable \$1 per-share pricing by MMFs. The valuation method accretes one additional day's worth of imputed interest on each portfolio asset each day (or amortizes a premium) using factors and information known in advance. This means that, absent a material credit event during the day that drops NAV below 99.5 cents per share, at 6:00 a.m., the system operators know what a share will be worth at 6:00 p.m. It will be priced at exactly \$1.00 per share. If MMFs were required to price shares at a continuously floating NAV, the exact price of a share as of the close of the day would not be known until after the markets close that day; the availability of pricing during the day would depend on (1) how frequently a MMF would be able to obtain portfolio valuations from its pricing service, and (2) the delay between a MMF's receipt of a redemption request and the determination of portfolio valuations (see below). Floating NAV MMFs must determine the purchase or redemption price of a share using the market-closing valuations of the portfolio instruments that are not known until the next close of markets *after* that purchase or redemption order is placed.¹

In other words, if MMFs used a floating NAV, the system operator would not know until several hours after the market closes whether a share would be worth \$1.0001 or \$0.9999 at the end of the day. When the automated system learned in the morning that it must purchase or liquidate MMF shares to process a payment of say, \$10,000,000 that afternoon, and placed that order, it would not be clear at the time the order was placed exactly how many MMF shares would have to be liquidated to reach that exact amount. It might be a few cents more or less at the end of the day than anticipated. This few extra or short pennies would be a discrepancy that would need to be manually reconciled and the difference trued up before the transaction could be finished. Manual processing would mean more staffing requirements, more costs associated with staffing the function, and errors and delays in completing the process.

Furthermore, because the purchase and redemption price would not be known earlier, and the market-closing valuations from after the purchase or redemption order was placed must be used to set the price for the purchase or redemption order, the settlement payment could not occur the same day the order is placed (T+0), but instead would be made the next business day (T+1) – unless intra-day valuation and pricing is instituted, with prices struck several hours after the receipt on an order. For transactions occurring later in the day, this means one party to the transaction owes the other money for one more day (three if it is a weekend, four if a holiday weekend). Both parties would carry the unsettled transaction as an open position for one extra day and each party would be exposed for that time to the risk that its counterparty would default during the extra day, or that the bank holding the cash overnight (or over the weekend) would fail. For a bank involved in making a payment in anticipation of an incoming funds transfer as

¹ 17 C.F.R. §§ 270.2a-4, 270.22c-1.

September 13, 2013

Page 3

part of these processing systems, this change from same-day to next-day processing of MMF redemptions would turn intra-day overdrafts into overnight overdrafts, resulting in much greater default and funding risks to the bank. This extra day's float would mean more risk in the system and a larger average float balance that each party must carry and finance.

Maintaining a penny-rounding convention for pricing shares of certain government and "retail" MMFs, while abandoning amortized cost accounting in favor of mark-to-model valuation of portfolio assets, does not resolve this problem. Portfolio valuations using amortized cost accounting stay the same all day unless there is a highly unusual credit event. This allows frequent and efficient intraday pricing of shares and flexibility in the coordination of timing of orders and settlements with the cash flows driven by the shareholders' related payments. In contrast, when mark-to-model valuations are used to value portfolio assets, the MMF must determine a price after the order is received and before settlement using input from a pricing service that takes new inputs into account in the model (for example, price movements in traded "anchor" bonds and interest rates that are used as inputs by the pricing model). Even when share prices are rounded to the nearest penny, and intraday prices are used, the time to strike a new price using mark-to-model portfolio valuation is several hours each time it is done, and there are additional fees paid to the pricing service and additional staff time required of the MMF's accountant to calculate and strike the new price. The additional time and cost of determining share prices means that the last order cut off before FedWire and other payment systems close must be earlier in the day than when amortized cost is used to value portfolio assets. Moreover, the processing lag time also means that prices are struck fewer times during the day and there is at least a lag of several hours between the time a purchase or redemption order is placed and the transaction settles, which makes it more difficult to coordinate on an intraday basis the timing of the cash flow from the MMF share purchase or redemption with the offsetting cash flow from the investor's underlying business transaction.

The net result of a floating NAV or a fixed NAV calculated by pricing portfolio assets using mark-to-model valuation and rounding shares to nearest penny would be to make MMFs not useful to hold the large, short-term cash balances used in these automated transaction processing systems across a wide variety of businesses and applications. A generation's worth of work in automating settlement systems, shortening settlement times, and limiting counterparty risk would be undermined. At a minimum this would require systems to be re-programmed on a wide scale, involving substantial personnel, time and years to complete. This would be comparable in some ways to the Y-2K effort, although the effort would be concentrated at fewer firms, but more work required at each affected firm to redesign and reprogram their processing and accounting systems. Completion of the systems would take many years and hundreds of millions of dollars to complete across a wide range of businesses and applications for which stable value MMFs currently are used to hold short-term liquidity. Until these systems could be redesigned, reconfigured and rebuilt, processing of transactions would essentially be back to the manual processes that existed in the early 1970s.

September 13, 2013

Page 4

If MMFs no longer provide a business solution for holding short-term cash balances for each of these various processing functions, something else would need to be used. The vehicles that formerly held these pending balances before MMFs filled this need included credit balances at the commercial counterparty (due to and due from amounts at a commercial company, or free credit balances at a broker), bank short-term investment funds, corporate variable amount notes, and bank deposits. These vehicles have fallen out of use for this purpose or might no longer be available, and each carries with it much greater and more concentrated default risks. While the Commission's Release sets forth a "range of options" for MMF users to access as alternatives to MMFs, none offers the combination of daily liquidity, stable value, low risk with a market yield, transparency, and regulatory oversight offered by MMFs.

Examples of some of the transaction processing systems that use MMFs to hold short-term cash balances are set forth below, along with a description of how MMFs fill a business need of that particular system.

Bank Trust Accounting Systems. Bank trust departments are responsible for receiving, tracking, accounting for, holding in custody, investing, and paying out cash balances for large numbers of trust accounts. This cash includes balances from many different trust and fiduciary accounts. It represents cash received from the proceeds of sales of securities or other assets, dividends and interest on client investments, and new balances placed in trust. The cash is held briefly pending distribution to beneficial owners, payment of expenses and taxes on behalf of clients, and payments for purchases of securities and other assets for client fiduciary accounts. At any given time, the balance for any one client account may be very large or very small, but in the aggregate the trust department as a whole represents a very large, short-term cash balance. Trust departments have an obligation to keep trust assets productive, minimize the time cash balances remain uninvested, and seek a competitive return on cash balances consistent with prudent investment principles.²

Tracking, investing and accounting for these cash balances is a complex effort, due to the large numbers of fiduciary accounts which must be tracked, the many and varied inbound and outbound streams of cash, the need to plan and manage payments and distributions for the various client accounts, tax considerations, the non-uniform provisions of the many different trust instruments that govern the requirements of each different account, and the complex and overlapping requirements of state and federal laws governing fiduciary accounts. Fiduciary laws in many jurisdictions designate certain types of assets as permitted investments for trusts and certain other fiduciary accounts. MMFs have been recognized as permitted fiduciary investments in many states. A change to the regulatory requirements for MMFs that precluded

² 12 C.F.R. § 9.10.

September 13, 2013

Page 5

MMFs from using amortized cost or seeking to maintain a stable net asset value per share could lead state legislatures to amend fiduciary statutes to prohibit the continued use of MMFs to hold trust cash balances.

Among the many complexities of applicable fiduciary laws is a requirement in many jurisdictions to track and separately account for principal and income on each account, and requirements on diversification and in what assets a particular type of fiduciary account can be invested, as well as restrictions on conflicts of interest by the trustee bank.

Most bank trust departments operate on trust accounting systems provided by one of ten large national vendors. These automated, computer-based systems are designed to maintain records of client accounts, generate internal and external reports used by the trust department, as well as tax records and client statements, and interact with the investment and cash management programs of the bank on an automated basis.

In the past, trust departments generally held trust cash either on deposit with the commercial side of the bank, or in a “short term investment fund” maintained by the trust department. Both of these alternatives had significant operational problems. If placed on deposit with the commercial side of the bank, the fiduciary account deposit generally must be collateralized by high quality bonds,³ and must bear a competitive rate of interest.⁴ Depositing with the commercial side presents a conflict of interest that must be carefully managed and maintained only for a short period.⁵ This presents further complications under the reserve requirements of Regulation D, which require reserves to be placed by the bank with the Federal Reserve equal to 10% of a “demand deposit” portion of these cash balances.⁶ The combination of these factors makes it impractical in many cases for the commercial side of the bank to accept fiduciary deposits.

Short-term investment funds (or STIFs) present other challenges as a cash management vehicle for trust department cash. STIFs are a form of bank common trust fund invested in relatively short-term high quality debt instruments,⁷ and only certain types of bona fide fiduciary

³ See 12 U.S.C. § 92a(d); 12 C.F.R. § 9.10.

⁴ 12 C.F.R. § 9.10; *Md. Nat'l Bank v. Cumins*, 322 Md. 570, 588 A.2d 1205 (Md. 1991); *Van de Kamp v. Bank of Am. Nat'l Trust & Savs. Ass'n*, 251 Cal. Rptr. 530, 538 (Cal. Ct. App. 1988); *In re Orrantia's Estate*, 285 P. 266 (Ariz. 1930); *New England Trust Co. v. Triggs*, 135 N.E.2d 541 (Mass. 1956); *In re Doyle's Will*, 79 N.Y.S.2d 695 (N.Y. Surr. Ct. 1948); *In re Haigh's Estate*, 133 Misc. 240, 232 N.Y.S. 322 (N.Y. Surr. Ct. 1928); *Reid v. Reid*, 85 A. 85 (Pa. 1912).

⁵ *Id.*

⁶ 12 C.F.R. § 204.

⁷ 12 C.F.R. § 9.18(b)(4)(ii)(B).

September 13, 2013

Page 6

account balances from the bank that maintains the STIF and its affiliated banks can be placed in them. Revocable grantor trusts, investment management and custody accounts, IRA and pension and employee benefit plan assets cannot be placed with the other trust assets in a STIF due to requirements of the Investment Company Act exemption within which STIFs operate.⁸ Moreover, separate STIFs must be operated in order to segregate pension plan assets from assets in trust accounts. This results in a relatively small investable balance for each STIF (compared to MMFs) and therefore a substantial challenge in keeping the portfolio of the STIF fully invested in a diverse pool of high quality assets while matching the timing of cash flow requirements dictated by trust account investments in and redemptions from the STIF.⁹

One of the first major uses of MMFs was to hold these trust department temporary cash balances. MMFs provided a useful solution to bank trust departments which allowed them to invest balances of fiduciary accounts for short periods of times in an asset permitted by state fiduciary laws and trust instruments, at a competitive yield in a liquid, diverse pool of high quality debt instruments. Because a MMF can accept investors from many different banks' trust departments as well as other types of retail or institutional investors, a MMF can be much larger than a STIF and can accordingly achieve more portfolio diversification, better management of liquidity needs, and lower operating costs per dollar of assets, as compared to a STIF, and pay higher returns with less concentration of risk to trust accounts than a bank deposit. Use of amortized cost permits a MMF to anticipate NAV and share prices at the beginning of the day for the entire day (subject to the remote possibility that there will be an unexpected substantial credit event during the day that drops NAV below 99.5 cents per share), rather than needing to wait until after the close of the trading markets at 4 pm to know end-of-day NAV. This means the price of a MMF share can be anticipated at 6 am when the processing day begins.

Trust accounting systems interface with many different external systems on a daily basis. These include interfaces with systems of broker-dealer firms through which the trust department executes purchases and sales of securities for fiduciary accounts, systems providing notification of dividend and interest payments received through securities clearinghouses and payment agent banks, and systems for receiving and sending incoming and outbound payments through the banking system on behalf of fiduciary accounts. These electronic data communications generally involve a bilateral exchange of pending payment amounts stated in dollars and cents, which are followed subsequently by deliveries of those amounts.

⁸ Investment Company Act 3(c)(3) (exemption for bank common trust funds), 3(c)(11) (exemption for bank collective funds for pension and employee benefit plans); *In the Matter of Commercial Bank and Marvin C. Abeene*, SEC Rel. 33-7116 (Dec. 6, 1994).

⁹ See Martin E. Lybecker, *Regulation of Bank Trust Department Investment Activities: Eight Gaps, Seven Remedies, Part II*, 91 Banking L.J. 6 12-14 (1974); Martin E. Lybecker, *Regulation of Bank Trust Department Investment Activities*, 82 Yale L.J. 977, 984-86 (1973).

September 13, 2013

Page 7

In order to reduce errors and cash shortfalls, trust accounting systems typically post a debit to the cash position in the account immediately before or simultaneously with the placement of an order to purchase a security, which is transformed into a redemption order for shares of the MMF to generate cash to pay, the next day, for the security being purchased.¹⁰ These accounting systems require a predictable MMF NAV share value at the time the redemption order is placed for (i) the cash position to match the cash needed to settle the purchase order and (ii) the ending balance reflected as available in the MMF to be accurate for processing any other transactions in the customer account that day.

Predictability in the per share price of MMFs is critical to the operation of trust accounting systems, allowing them to be more fully automated (rather than relying on manual processes and the staffing costs, delays and errors associated with manual posting and processing of transactions and cash balances), allowing an exact sweep of cash balances to the penny, and permitting same day processing of cash payments. This permits same day (T+0) or next day (T+1) settlement of portfolio securities transactions for fiduciary accounts, which in turn reduces the amount of settlement cash, “due to” and “due from” “float” in the trust department and overnight overdrafts and out-of-balance trust accounts. This, in turn, means less counterparty risk and shorter time for client fiduciary assets to be less than fully invested.

Federated has been informed by the vendors of each of the major trust accounting systems that their systems are not designed to process cash balances using MMFs with a continuously floating NAV. Forcing MMFs to move to a continuously floating NAV would make MMFs incompatible with the major trust accounting systems. Until these trust accounting systems could be redesigned and reprogrammed either to accept a pricing feed with a continuously floating NAV (assuming it could be done at all and trust departments would accept it) or use some other vehicle to hold cash balances, trust departments would essentially be forced to use more manual processing, returning them essentially to the 1970s.

Corporate Payroll Processing. Most companies pay their employees either twice per month or every two weeks. Generally, pay is disbursed to all employees on the same days. The pay is either distributed in a direct deposit to an account previously designated by the employee, or in a physical paycheck given to the employee. The aggregate amount of money involved in each payroll disbursement is very large. The bigger the company, and the larger its employee base, the larger is the aggregate amount of cash involved. The corporate treasury department manages its cash availability through a variety of short-term investments that are sufficiently liquid to address scheduled payments that must be made. Payroll is a very large and recurrent payment amount.

¹⁰ See Letter from ASC to Eugene F. Maloney (Oct. 16, 2008) (on file with recipient).

September 13, 2013

Page 8

Pending distribution to employees, the cash must sit somewhere. Large companies commonly use third-party vendors to handle payroll processing, but employers are not eager to incur the credit risk of such vendors on payroll balances, even for a short period of time. For a given pay period, the aggregate payroll amount for a large company is many millions of dollars, well in excess of the standard \$250,000 FDIC deposit insurance limits. If the entire balance is placed on deposit at a bank, and the bank fails, the company is at risk of losing a large portion of the payroll balance in excess of \$250,000. Companies with large payrolls are understandably anxious about limiting their loss exposure in the event of the insolvency of a bank. From the bank's perspective, many banks are not eager to take on multi-million dollar deposit balances for periods of a few days each month, because there are costs involved with having those balances on the bank's balance sheet and the bank is not able to profitably invest the cash for such a short period of time.

As an alternative, many large employers place cash pending distribution of payroll into MMFs, with an automated sweep into the payment system and vendor used by the employer. A MMF knows in advance, through communications with the employer and experience, how much money is coming in and out and when it will arrive and depart, and is able to profitably invest the proceeds through the MMF's portfolio for a few days in short term instruments, carefully managing the cash position of the MMF with advance knowledge of the amounts and schedules of the payroll arrival and disbursement.

Key features that allow MMFs to work to hold short-term balances for corporate payrolls pending distribution include the use of amortized cost and a stable NAV of \$1 per share, which allows for a predictable value of share prices throughout the day (rather than needing to wait for end-of-day market close prices to know share prices and processing of purchases and redemptions after 4:00 p.m.) and same-day processing of investments and redemptions of shares. Moreover, use of amortized cost to value portfolio assets, rather than penny rounding of share prices using mark-to-model portfolio values, allows for better coordination of settlements of MMF share purchases and redemptions with the timing of funds flows for payrolls. The bank that is processing the payroll distributions makes payments as checks and other items are presented through the banking system, and is able to redeem shares of the MMF and receive payment on a same day basis and avoid an overnight overdraft. If MMFs were required to use a continuously floating NAV, purchases and redemptions may need to be processed on a next-day basis. This would require either (i) that large balances be redeemed and held as cash overnight or over a period of days as items are presented to the bank, creating an exposure by the employer to the credit risk of the bank for large amounts of money, or (ii) leaving the bank exposed to the risks associated with overnight overdrafts pending receipt of cash from the MMF or directly from the employer.

Moreover, if a continuously floating NAV is required for MMFs, on a multi-million dollar balance, the value of the MMF shares would move around a small amount, such that the

September 13, 2013

Page 9

payment sent by the employer and held in the MMF for a few days would be a few dollars over or a few dollars short of the gross payroll amount each payroll period. This, in turn, would require more manual processing, creating more delays and errors, and significantly undermining the usefulness of MMFs to employers, banks and payroll processors. Even if share prices are rounded to the nearest penny, without the use of amortized cost accounting to value portfolio assets, intraday settlements can only be conducted on a less frequent basis and with longer delays between transaction placement and processing, resulting in earlier cut-off times to meet payment system deadlines, delays and risk from larger pending transaction balances, larger “daylight overdrafts” in payment systems, and greater difficulties coordinating cash flows from the share purchases and redemptions with the offsetting payroll payments.

Corporate and Institutional Operating Cash Balances. In addition to payroll balances, companies have other payments received, as well as incoming cash from operations, and closely manage those cash balances in order to meet their payment obligations as they occur. Large companies typically have a corporate treasury management function to handle the liquidity needs and short-term investment of the company’s assets.

The balances involved at a company at any given time can be very large. Due to low (or zero) interest rates on short-term corporate deposits and the risk of bank failure when balances are in excess of the \$250,000 FDIC deposit insurance limits, leaving large amounts of cash on deposit at a bank is not a good alternative.

Traditionally, larger corporate treasury departments managed cash balances by holding separately managed portfolios of direct investments in commercial paper, treasury bills, and other high quality short-term debt instruments. Many corporate treasurers have found it more efficient to invest a portion of those short-term balances in MMFs. This allows for professional management at a lower cost of a diverse portfolio with greater liquidity than the company’s treasury desk could accomplish on its own. In this context, MMFs are an alternative to an individually-managed portfolio of securities.

Use of amortized cost accounting which has resulted in nearly all circumstances over the past 35 years in a stable NAV of \$1 per share provides a simple means for MMF balances to be integrated into the internal accounting and cash management systems used in corporate treasury departments. Same day processing of MMF share purchases and redemptions allows MMFs to be used more efficiently by corporate treasurers and permits a more automated interface among the internal accounting systems used by the corporate treasury department, the banks through which the company sends and receives payments, and the MMF’s transfer agent. This, in turn, reduces float in the system, overnight overdrafts by the corporation’s banks and the balances of the corporation with its banks in excess of FDIC deposit insurance limits. Even if share prices are rounded to the nearest penny, without the use of amortized cost accounting to value portfolio assets, intraday settlements can only be conducted on a less frequent basis and with longer delays

September 13, 2013
Page 10

between transaction placement and processing. The result will be an inability of MMFs to meet the needs of corporate treasury departments, which require frequent intraday processing and settlement to meet their payment needs as they arise.

Federal, State, and Local Government Cash Balances. Like businesses, governments have cash management needs. Many state, local and federal government bodies use MMFs as an efficient means to invest short term liquidity balances. Governments have payrolls to pay and operating cash balances to invest for short and medium periods of time. Government cash balances often are tied to tax payment cycles and expenditures tied to fiscal year budgets. Investment of the balances is subject to a myriad of state and local government requirements on investment of government assets, and in some cases to Internal Revenue Service requirements. These state and local laws commonly include lists of permitted investments that specifically authorize investments in MMFs, defined in terms of a fund that seeks to maintain a stable net asset value per share.¹¹ A change to the regulatory requirements for MMFs that precluded MMFs from using amortized cost or seeking to maintain a stable net asset value per share would require many state and local government statutes to be amended by the state legislature to permit the continued use of MMFs by the state or local government.

Although placing the funds on deposit at a bank is an alternative, government deposits frequently are required to be collateralized with high quality bonds,¹² which make them expensive for the bank to hold. Another alternative is for the state or local government to attempt to manage a portfolio of direct investments in individual money market instruments, although this is a more expensive, higher risk and ultimately less liquid means of investing cash balances of state and local governments than investing in MMFs. An unintended consequence to a movement away from amortized cost and a stable value of \$1 per share would be to diminish the ability of state and local governments to use MMFs and to force them into less liquid, more expensive, higher risk alternatives for investment of cash portfolios.

Municipal Bond Trustee Cash Management Systems. State and local governments raise money for general operations and for specific projects through the issuance of municipal bonds. Each bond issuance has an indenture with a bank as bond indenture trustee and payment agent to handle various aspects of the bonds' issuance, payment of interest and ultimate retirement. Substantial cash balances flow through the bond trustee and paying agent bank, with which cash payment must be made on time every time pursuant to the contractual terms of the bonds to avoid default. In many cases, the credit quality and credit rating of the bond issuance is tied to a very carefully developed cash management program designed to assure that there will

¹¹ See, e.g., N.J. STAT. ANN. § 18A:20-37; S.C. CODE ANN. §§ 6-5-10(6), 12-45-220; Tex. Gov't Code Ann. § 2256.014 (West); COLO. REV. STAT. § 24-75-601.1; Op. Ind. A.G. No. 96-3 (Sept. 5, 1996).

¹² 12 U.S.C. §§ 1821(a)(2), 1823(e)(2).

September 13, 2013

Page 11

be cash available to make scheduled interest payments and sinking fund retirements of the bonds. The trust indenture of the bond, as well as state and local government laws and IRS requirements dictate certain aspects of how and into what types of assets the cash balances can be invested pending payment or distribution.

Leaving large amounts of cash on deposit at a bank results in a concentration of credit exposure that in some cases is not acceptable to bondholders. In addition, because the liquidity balances flow through the bond trustee and payment agent over relatively short periods of time, a bank may not be able to profitably invest the cash on a short term basis. As a result, MMFs are used in many cases to hold portions of the short term liquidity pending payment or distribution on scheduled dates.

Use of amortized cost accounting and a stable NAV of \$1 dollar per share allows MMF balances to be integrated into the accounting systems used in the corporate trust department of the bank that serves as bond trustee. Same day processing of MMF share purchases and redemptions, which is not possible with a floating NAV MMF, allows MMFs to be used more efficiently by the bond trustee and payment agent. This, in turn, reduces float in the system, overnight overdrafts by the payment agent bank and the balances of the issuer with its bank in excess of FDIC deposit insurance limits.

Moreover, even if share prices are rounded to the nearest penny, without the use of amortized cost accounting to value portfolio assets, intraday settlements can only be conducted on a less frequent basis and with longer delays between transaction placement and processing, resulting in earlier cut-off times to meet payment system deadlines, delays and risk from larger pending transaction balances, larger “daylight overdrafts” in payment systems, and greater difficulties coordinating cash flows from the share purchases and redemptions with the offsetting payments.

A trust company president described the importance of MMFs with a stable NAV of \$1 per share to the investment of cash amounts associated with municipal bonds as follows:

Until the advent of money market mutual funds, state and local government entities investing bond proceeds for infrastructure projects were extremely limited in scope to the manner in which bond proceeds could be invested. The work that we did collectively to have state statutes passed to allow a broader investment product array by utilizing money market funds as “permitted investments” has allowed for the minimization of market risk

If for some reason the maintenance of a stable \$1.00 value by money market mutual funds is at risk, we will see a mass exodus of investors

September 13, 2013

Page 12

from the institutional side of the business, such as Reliance Trust Company. This exodus will expose all investors to increased processing costs, substantially greater risk and liability, limited choices of investment vehicles primarily because of statutory restrictions and far greater exposure to credit risk.¹³

Consumer Receivable Securitization Cash Processing. The structures used for issuance of mortgage-backed bonds and other securitizations of consumer receivables share some of the attributes and cash management needs of municipal revenue bonds, but the cash flows are far more complicated and less predictable. Many of the structures require an initial cash balance and additional retention, build-up and hold back of significant amounts of cash from payments received on the underlying consumer receivables as a “prefunded account” in order to assure timely payment of the senior tranches of the securitization.¹⁴ These cash hold-backs serve some of the same purposes as a back-stop letter of credit from a bank, which may also be in place in addition to the cash hold-back. The prefunded account reduces the likelihood of the need to draw on the letter of credit and the potential size of that draw. MMFs are used as a more efficient and lower risk alternative to direct investment by the indenture trustee of the prefunded balances in a portfolio of individual money market instruments.

MMFs are used in some cases to hold portions of these cash balances, for essentially the same reasons described above – MMFs limit counterparty risk exposure to any one bank, and the stable NAV permits same day processing of share redemptions and more convenient inclusion of balances in the complex accounting systems needed to track payments and disbursements in these securitization structures.

The permitted instruments into which cash balances can be invested generally are specified in the trust indenture and other governing documents of the structure and cannot readily be changed after the securitization structure is launched and its securities sold to investors. Changing the regulatory attributes of MMFs could compromise their role in holding short-term liquid assets in securitization structures.

Escrow Processing. Money is placed in escrow in connection with a variety of transactions ranging from the purchase of a home to corporate acquisitions. The basic purpose is similar -- to place a cash balance into the hands of an independent party to make a payment on a contractually specified amount when certain conditions are met. The amounts per customer may be a few thousand dollars for mortgage escrows to hold tax and insurance payments, or billions

¹³ Letter from Anthony A. Guthrie, President, Reliance Trust Company to Eugene F. Maloney, Federated Investors, Inc. (Oct. 17, 2008) (on file with recipient).

¹⁴ See *Federated Investors, Inc.*, SEC Staff Letter 1997 SEC No-Act LEXIS 716 (July 8, 1997).

September 13, 2013

Page 13

of dollars in a corporate M&A transaction. The funds may be held for a few hours, days or months. The amounts held by an escrow agent commonly exceed deposit insurance limits of \$250,000. If pass-through deposit insurance treatment is not available, or if the amounts per ultimate beneficial owner exceed \$250,000, allowing the escrow agent to place the escrow balance in a bank deposit may not be an acceptable risk to the parties. Escrow agreements commonly allow the parties to direct the escrow balances be held in shares of a designated MMF, as a way of limiting counterparty risk.

MMFs are useful for this purpose because they do not represent the credit risk of a single issuer, but instead represent a diversified pool of high-quality short term debt obligations of many underlying issuers. In addition, because the value of the shares do not fluctuate, the escrow agent can hold an amount representing exactly what must be paid if the conditions to completion are met and the escrow amounts paid out on settlement. For escrows on purchases of companies with many shareholders, the accounting systems needed to assure exactly the correct amounts are paid to the proper shareholders are complex. Similarly, escrow agents that process mortgage-related tax and insurance escrows use complex automated accounting systems that must track and account for a large number of consumer escrow accounts each with different balances and payment amounts.

The use of amortized cost permits the share price of a MMF to be anticipated in the morning (because the daily amortization factors are known for each portfolio security) for the day, rather than known only after the closing of the markets at 4:00 p.m. This permits a share price to be used at a stable dollar amount throughout the day by the automated accounting and payment processing systems used by escrow agents. Moreover, the use of amortized cost also permits same-day settlement of purchases and redemptions of MMF shares. These two features – a stable share price throughout the day and same-day settlement – are key to the utility of MMFs to hold temporary cash balances for escrow agents. Even if share prices are rounded to the nearest penny, without the use of amortized cost accounting to value portfolio assets, intraday settlements can only be conducted on a less frequent basis and with longer delays between transaction placement and processing, resulting in earlier cut-off times to meet payment system deadlines. If MMFs were required to use a continuously floating NAV, they would not be as useful to escrow agents, the escrow agents' accounting systems would need to be redesigned and reprogrammed to accommodate a floating NAV, and payment cycles would be delayed by a day. If escrow agents continued to use MMFs at all, there would be one extra day to closing required, and that delay means one extra day of counterparty risk. In addition, the cash balance would likely need to sit in a bank account overnight, adding the risk of bank failure during that period.

Custody Cash Balances and Investment Manager Cash Balances. Banks serve as custodians for securities accounts of commercial and individual customers. Securities purchases

September 13, 2013

Page 14

and sales orders are placed by the customer (or its investment adviser)¹⁵ with a securities broker and the custodian bank is notified of the transaction. The custodian bank communicates settlement instructions with the broker-dealer. Custodial cash is commonly invested in MMF shares, in part because the cash balances commonly exceed the \$250,000 FDIC deposit insurance limit. When it receives instructions to deliver cash to a broker-dealer to settle a transaction, the custodian bank redeems shares of the MMF. Same-day settlement of MMF shares (T+0) permits the cash to be available to settle the securities transactions the next day (T+1). Even with share prices rounded to the nearest penny, without the use of amortized cost accounting to value portfolio assets, intraday settlements can only be conducted on a less frequent basis and with longer delays between transaction placement and processing. As a result, with a continuously floating NAV, there would be an additional business day required to redeem MMF shares, which would move the settlement cycle for the securities transaction back one day (T+2).

401(k) and 403(b) Employee Benefit Plan Processing. Private employers over the past few decades have shifted from defined benefit retirement plans to defined contribution plans due to the high costs and potentially large unfunded liabilities associated with defined contribution plans. Two common and highly popular forms of participant-directed defined contribution plans are 401(k) and 403(b) plans, which draw their names from provisions of the Internal Revenue Code. Among the requirements applicable to these plans under the Department of Labor rules implementing the Employee Retirement Income Security Act (ERISA) are that, in order to limit the liability of plan trustees, a stable value option be included as part of the plan to hold cash contributions for which a participant has not yet provided investment instructions.¹⁶ MMFs are an investment option eligible to meet this requirement for up to 120 days.

In addition, cash balances in participant accounts must be segregated from the assets of the plan trustee and held during brief periods of time when a plan participant is changing the investment allocation of the participant's account. MMFs serve this purpose within 401(k) and 403(b) plans.

The use of amortized cost and \$1 per-share pricing at MMFs allows for same-day settlement, and allows the value of shares to be known throughout the day. If MMFs were required to use a continuously floating NAV, it might further delay the settlement of transactions and share prices could fluctuate very slightly and would not be known with certainty until after 4:00 p.m. each business day, unless funds are able to price on an intraday basis. Even with share prices rounded to the nearest penny, without the use of amortized cost accounting to value portfolio assets, intraday settlements can only be conducted on a less frequent basis and with

¹⁵ See 17 C.F.R. § 275.206(4)-2 (customer accounts of registered investment advisers required to be held in custody of bank or broker-dealer).

¹⁶ See 29 C.F.R. § 2550.404c-5 (Department of Labor Qualified Default Investment Alternative Regulations).

September 13, 2013

Page 15

longer delays between transaction placement. This would limit the utility of MMFs for use with the automated accounting and processing systems used by vendors that provide 401(k) and 403(b) plans, and if MMFs continued to be used at all, would increase settlement times by at least one day, increase float in the system, require a process for reconciling and truing up order amounts to reflect small variations in the value of MMF balances and require a significant redesign and reprogramming of the accounting and processing systems used by 401(k) and 403(b) plans to accept a floating NAV MMF to hold temporary cash balances.

Broker-Dealer and Futures Dealer Customer Cash Balances. Customer accounts at securities broker-dealers carry cash balances that are used to make payments on amounts owed by the customer on purchases of securities. This cash belongs to the brokerage customer. Cash flows into the brokerage account through cash amounts added to the account by the customer, dividends and interest on investments held in the account, and from the proceeds of sales of securities.

If the brokerage customer's cash balance is not invested in something, it sits as a "free credit balance" which is simply a "due to" amount owed to the customer by the brokerage firm. To protect customers against the risk of a failure of the broker-dealer firm (and ultimately the SIPC which guarantees customer cash balances up to \$250,000 per account), the broker-dealer is required to hold bank deposits or certain types of securities in a segregated account for the exclusive benefit of its customers, in an amount at least equal to the net unencumbered amounts of customer "free credit balances."¹⁷

As an alternative to holding customer cash as free credit balance liabilities of the broker-dealer, brokerage firms normally provide a cash sweep program by which customer cash balances are "swept" into investments in shares of MMFs which are then owned by the customer but held in custody through the broker-dealer. Investment of the cash balances into MMF shares segregates these customer assets from the assets of the broker-dealer and removes them from the balance sheet liabilities of the broker-dealer.

Because MMF redemptions settle same day (T+0), cash is available very quickly to pay for customer purchases of securities, or to receive incoming cash from the sale by the customer of a security. This same day cash availability is important to avoid customer "fails," and to assure compliance with the margin rule requirements applicable to brokerage accounts which require cash availability in the account when a customer places an order in a customer cash account and margin collateral coverage in a customer margin account.¹⁸ In addition, the use of

¹⁷ 17 C.F.R. § 240.15c3-3.

¹⁸ See Regulation T, 12 C.F.R. Part 220. The margin rule treats MMFs shares essentially as the equivalent of cash for this purpose.

September 13, 2013

Page 16

amortized cost and a stable NAV of \$1 per share allows efficient processing of cash balances by the accounting system of the broker-dealer throughout the transaction processing cycle at a known and predictable amount, and communication with the accounting systems of the transfer agent of the MMF. This allows the use of MMFs as a means to hold cash balances within the automated accounting and transaction processing systems used by the broker-dealers, which in turn reduces settlement times, pending transaction float balances and fails, and the counterparty risk in the system.

Even with share prices rounded to the nearest penny, without the use of amortized cost accounting to value portfolio assets, intraday settlements can only be conducted on a less frequent basis and with longer delays between transaction placement and processing, resulting in earlier cut-off times to meet payment system deadlines, delays and risk from larger pending transaction balances, larger “daylight overdrafts” in payment systems, and greater difficulties coordinating cash flows from the share purchases and redemptions with the offsetting payments. As a result, floating NAV MMFs will not be as useful to brokerage customers, who rely on the ability of MMFs to provide frequent intraday processing and settlement with short turnaround times to meet their intraday transaction payment needs.

Similarly, rules of the Commodity Futures Trading Commission (“CFTC”) require the segregation of customer cash balances at a futures firm used to pay for (and provide margin collateral for) futures transactions placed by a customer.¹⁹ MMFs serve the same function at futures firms as they serve at securities broker-dealers -- hold customer cash balances, and to collateralize amounts due or potentially due on futures positions of the customer held through the futures firm. The CFTC reaffirmed the continued appropriateness of MMFs to hold customer liquidity balances in December 2011 after careful review and a lengthy rulemaking proceeding.²⁰ The CFTC determined through this process that MMFs satisfy the statutory objective that “customer segregated funds must be invested in a manner that minimizes their exposure to credit, liquidity, and market risks both to preserve their availability to customers . . . and to enable investments to be quickly converted to cash at a predictable value in order to avoid systemic risk”²¹ as well as the Regulation 1.25 prudential standard that all permitted investments be “consistent with the objectives of preserving principal and maintaining liquidity.”²²

¹⁹ 17 C.F.R. § 1.20.

²⁰ CFTC, *Investment of Customer Funds and Funds Held in an Account for Foreign Futures*, 76 Fed. Reg. 78776 (Dec. 5, 2011).

²¹ *Id.* at 78776.

²² *Id.* (citing 17 C.F.R. § 1.25(b)).

September 13, 2013

Page 17

Broker-dealers and futures dealers are subject to regulatory requirements specifying the types of assets that the entity can own and the types of assets that can serve as collateral or be used to invest client cash balances. Many of these regulatory provisions specifically include as a permitted investment MMF shares that seek to maintain a stable net asset value per share.²³

The ability of securities broker-dealers and futures commission merchants to shorten settlement times and reduce the systemic risks associated with unsettled transactions has been facilitated by the ability of MMFs to process purchases and redemptions of shares on a same day (T+0) basis, which in turn is only possible as a result of using the amortized cost method of accounting. Requiring MMFs to use a continuously floating NAV would require them to move to next-day settlement and lengthen settlement times of securities transactions by at least one day. The securities industry has spent the past 35 years shortening settlement times in order to reduce systemic risk. Using MMFs to hold short-term cash balances in connection with the transaction settlement process has been an integral part of how that was accomplished. Even with share prices rounded to the nearest penny, without the use of amortized cost accounting to value portfolio assets, intraday settlements can only be conducted on a less frequent basis and with longer delays between transaction placement. As a result, an unintended consequence of the movement of MMFs to a continuously floating NAV (or the elimination altogether of MMFs) would be longer securities transaction settlement cycles and an increase in systemic risk.

Cash-Management Type Accounts at Banks and Broker-Dealers. Brokerage firms and banks offer “cash management” type accounts that permit customers to access cash balances in their brokerage accounts by check or debit card. Millions of retail customers find these accounts to be convenient. Cash balances in these accounts are held either in MMFs or in brokered deposits at banks. Checks and debit cards are processed by a bank for the brokerage firm. The payments of these items are funded by cash received from redemptions of MMF shares held in the customer’s brokerage account. The bank runs nightly files of items presented for payment, which triggers a redemption of MMF shares. The bank advances payment on the items after confirming electronically MMF shares are being redeemed to repay the bank on the advance of funds. The cash from the redemptions is then sent to the bank.

Processing the transactions is done on an automated basis, requiring a series of electronic data exchanges among the bank that issues the debit card and processes the checks, the brokerage firm that carries the customer’s brokerage account, and the transfer agent of the MMF which processes the redemption requests and forwards payment to the bank.

²³ N.Y. Mercantile Exchange Letter to Mr. Richard Recker, Federated Securities Corp. (May 18, 2001); Options Clearing Corp. Memorandum to all Clearing Members (Feb. 18, 2005).

September 13, 2013

Page 18

Use of amortized cost and stable value of \$1 per share is crucial to processing these accounts because it permits same-day processing of MMF share redemptions. This allows the bank to limit its credit exposure and avoid overdrafts and “NSF” or “bounced” checks. Use of a predictable \$1 per share value is also critical to the interface among the accounting systems. The systems are programmed to work on a stable value of \$1 per share. A continuously floating NAV would result in transactions being a few pennies over or short each day, which would require manual processing of the transactions. In the alternative, if the accounting systems were reprogrammed to address a continuously floating NAV by submitting the redemption request as a dollar amount rather than a number of MMF shares, the account balance remaining after a MMF share redemption is processed would be off by a few pennies per day, requiring inclusion of a larger buffer balance in the customer’s account to ensure a sufficient available cash balance to avoid fails and overdrafts in subsequent transactions by the customer in the account, and additional work by the customer to keep track of available balances in the account.

For debit cards, there is a two step-process notification and payment of items is separated by a few days. First, at point of sale, the merchant sends an electronic signal through the banking system that the customer is buying something at a certain price, and the available balance is confirmed and a hold placed on that balance at the MMF. A few hours or days later, the merchant submits the debits for payment through the banking system, which submits the items for payment to the bank that issued the debit card and, which makes the payments. The bank then sends a signal to redeem the MMF shares that are on hold, to repay the bank for the advance. If the MMF shares continuously floated up and down in price between the time between when the hold was placed and the shares redeemed, the payments would be off a little bit each time, requiring manual processing. If same day settlement of MMF redemptions were not available, the bank would not be reimbursed on the same day that it advanced payment on the debit card items. Same-day cash would not be available to the entity “sourcing” the transaction. This would require cash funding flow changes throughout the funding chain and could require some participants in the process to carry an overnight overdraft until the cash arrives the next business day. Additionally, as entities authorizing debit/POS/ATM transactions based on an “Available Balance” data delivered to them by the transfer agent or brokerage platform, that balance could be slightly off as the shares representing that balance change based on end-of-day floating NAV pricing. Currently, these workflows and systems all assume a stable NAV of \$1 per share throughout the chain of processing and same day processing of MMF share redemptions. Any change to that assumption will require a retooling of the workflow and cash flow timing to accommodate cash availability and delivery.

Moreover, even with share prices rounded to the nearest penny, without the use of amortized cost accounting to value portfolio assets, intraday settlements can only be conducted on a less frequent basis and with longer delays between transaction placement and processing, resulting in earlier cut-off times to meet payment system deadlines, delays and risk from larger pending transaction balances, larger “daylight overdrafts” in payment systems, and greater

September 13, 2013
Page 19

difficulties coordinating cash flows from the share purchases and redemptions with the offsetting payments. As a result, floating NAV MMFs will not be as useful to brokerage customers, who rely on the ability of MMFs to provide frequent intraday processing and settlement with short turnaround times to meet their intraday transaction payment needs.

Banks offer a substantially similar product without the brokerage account. In the bank version, the bank offers a checking account with a debit card and ATM access, with balances above a set dollar minimum (which often is \$0) swept into shares of a MMF.²⁴ The bank pays items after they are presented and after verifying there are enough MMF shares owned by the Customer. The bank places an order to redeem MMF shares to repay the advance.

²⁴ See 1934 Act § 3(a)(4)(B)(v) (MMF sweep account exemption for banks in definition of securities “broker”), Regulation R, 12 C.F.R. § 218.741, 17 C.F.R. § 247.741 (same).