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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 Alternative One

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] Federated has submitted a prior letter to the Commission detailing the burdens, disruptions, and costs that would result from requiring money market mutual funds ("MMFs") to adopt a floating net asset value ("NAV"), as required by Alternative One.[2] Our comments in this letter will address why the exemptions included in Alternative One, for the purpose of preventing the floating NAV requirement from impacting "retail" investors and tax exempt and "government" MMFs, fail to accomplish their intended purpose.[3] In brief, the Release proposes the following:

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

[2] As discussed in our letter dated September 13, 2013, we do not believe the Commission should adopt the floating NAV proposal because a floating NAV would destroy key operational features that make MMFs useful to investors, would create operational, tax, accounting, legal, and other burdens that will drive away users and result in a significant shrinkage of MMFs, and would be enormously costly to investors and the economy, without furthering the Commission's goal of preventing or reducing the risk of "runs" in a crisis. Letter from John D. Hawke, Jr. on behalf of Federated Investors to SEC (Sept. 13, 2013) (available in File No. S7-03-13).

[3] Under the proposed rule, a MMF is defined as a U.S. Government MMF 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 if the fund does not permit any shareholder of record to redeem more than $1,000,000 per business day. Release at 37000.

An exemption for "retail" investors. The Release would exempt MMFs that limit redemptions by a shareholder of record to $1 million on any one business day from the requirement to price shares at a floating NAV (defined in the Release as a "retail MMF"). According to the Release, because retail investors are less likely to redeem in times of market stress, and because retail funds "generally do not have a concentrated shareholder base and are therefore less likely to experience large and unexpected redemptions," a floating NAV is not necessary to permit MMFs with retail shareholders to manage liquidity or large scale redemptions in a crisis.[4] The Release suggests, "[a] retail exemption may also reduce the operational burdens of implementing a floating NAV, because retail funds and their intermediaries may not need to undertake the operational costs of transitioning systems or managing potential tax and accounting issues associated with a floating NAV."[5]

An exemption for "government" funds. The Release would exempt government funds, as defined in the Release, from the requirement to price shares at a floating NAV. Government funds, according to the Release, do not need to adopt a floating NAV because –

> [t]he securities primarily held by government money market funds typically have even a lower credit default risk than commercial paper [held by prime MMFs] and are highly liquid in even the most stressful market scenario. . . . Investors have frequently noted the benefits of having a stable money market fund option, and exempting government money market funds from a floating NAV would allow us to preserve this option at a minimal risk.[6]

A "look through" approach to omnibus accounts. The Release would permit retail MMFs to apply the $1 million daily redemption limit to omnibus account holders on a "look through" basis (*i.e.*, to the transactions of each beneficial owner of the MMF's shares), provided the MMF has policies and procedures reasonably designed to allow the conclusion that the omnibus account holder does not permit any beneficial owner to redeem more than $1 million on any one business day. The Release's "look through" approach to applying the redemption limit in the omnibus context is an effort to recognize that "omnibus accounts can represent hundreds

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[4] Release at 36856.

[5] *Id.* at 36856-57.

[6] *Id.* at 36854-55.

or thousands of beneficial owners and their transactions," and would "often have daily activity that exceeds [the $1 million] limit . . . even though no one beneficial owner's transaction exceeds the limit."[7]

Elimination of amortized cost, but continued use of the penny rounding method. The Release would eliminate use of the amortized cost method of accounting by retail and government funds, and preclude the use of amortized cost to value individual portfolio securities except to the extent that other mutual funds are able to use amortized cost to value individual portfolio securities.[8] Retail and government funds would still be permitted to use the penny rounding method to achieve a stable value. The Release rationalizes that eliminating the use of the amortized cost method of accounting in favor of the penny rounding method is appropriate because the Commission is proposing to require MMFs to disclose daily share prices with portfolios valued using market factors and applying basis point rounding, and as a result stable value funds in any event would have to value their portfolio assets using market factors each day.[9] The Release also suggests that "penny rounding alone [is] an equal method of achieving price stability in MMFs . . . ."[10]

A retail exemption for tax exempt funds only if the funds apply the redemption limit. The Release does not contain an explicit exemption from the floating NAV requirement for tax exempt MMFs, based upon the assumption that investors in these funds will be individuals who likely will qualify under the retail exemption. As a result, those MMFs will be required to adopt a floating NAV unless they satisfy the proposed definition of a retail MMF by limiting redemptions by a shareholder of record to $1 million on any one business day.

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[7] *Id.* at 36860-61.

[8] The SEC would permit the use of amortized cost where the MMF's board of directors determines, in good faith, that the value of debt securities with remaining maturities of 60 days or less is their amortized cost, unless the particular circumstances warrant otherwise. *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).

[9] Release at 36855.

[10] *Id.*

As discussed below, these various assumptions do not bear out, and therefore, the exemptions will not alleviate the burden of the Commission's floating NAV proposal, but will instead add significant complexities and operational burdens.

(1) The intricate systems to monitor and control the $1 million daily redemption limit would be extremely difficult to develop, implement and operate, particularly for MMFs that are not direct sellers to the end customer. Even if the limit could be implemented, it would lead to significant processing delays, additional costs and barriers to entry for MMFs, and reduced market efficiency.

(2) Alternative One's $1 million daily redemption limit for certain MMFs is arbitrary and would render these funds unavailable to many investors, including individual investors, engaging in transactions that are large but not driven by an effort to redeem ahead of a declining share value. This would be true even in normal market conditions when there is no threat to the stability of a MMF's share value.

(3) The Release's assumption that tax exempt funds inevitably would qualify for the retail exemption, based on their investor base, is simply wrong.

(4) Despite the exemption from the floating NAV, the elimination of the amortized cost method of accounting for government and retail funds would push back settlement times by hours or even overnight, create settlement bottlenecks, increase costs and risks for shareholders, and introduce new risks from potential technology breakdowns and systems failures at pricing vendors, while achieving no regulatory purpose, because shares will ultimately be penny rounded to the same $1.00 per share price.

(5) By leaving government MMFs as the only viable stable value cash management vehicle for institutional investors, the Commission effectively is promoting the ability of the federal government to borrow at the expense of state and local governments and private issuers by funneling additional assets into government MMFs. This "crowding out" is contrary to the Commission's obligation to consider the effects of its rules on competition, market efficiency, and capital formation.

(1) The intricate systems to monitor and control the $1 million daily redemption limit would be extremely difficult to develop, implement and operate, particularly for MMFs that are not direct sellers to the end customer. Even if the limit could be implemented, it would lead to significant processing delays, additional costs and barriers to entry for funds, and reduced market efficiency.

As the Commission knows from prior reform efforts, it is extremely difficult to distinguish between "retail" and "institutional" investors for purposes of a regulatory definition.[11] Recognizing this definitional problem, the Commission instead has elected to base its proposed definition on a daily redemption limit, under the theory that the limit will force shareholders (in particular "institutional" shareholders) to "self-select" into the appropriate funds and thereby alleviate the disruptive effects of the proposal on retail shareholders. The Commission's proposed redemption limit, however, likely will fail to lead to this division because it almost certainly cannot be implemented. The operational complexity of identifying each shareholder of record's daily redemption levels on a real-time basis, particularly where fund sponsors offer shares through numerous intermediaries (each with its own software system and method of processing shareholder transactions) and shareholders own shares through multiple accounts, may be an insurmountable challenge of coordination. If the proposed rule's exemption cannot be implemented, it will not alleviate any burden on retail shareholders.

The Release speculates that its $1 million daily redemption limit "would be relatively simple to implement, since it would only require a retail money market fund to establish a one-time, across-the-board redemption policy" and because it "would not depend on a fund's ability to monitor the dollar amounts invested in shareholders' accounts, shareholder concentrations, or other shareholder characteristics."[12] But the Release's proposal does little more than choose one characteristic (a shareholder of record's daily redemption level) from the many it considered as the one which entities involved in the MMF transaction process would need to monitor for in administering a retail exemption. As discussed in our separate letter on the floating NAV proposal filed September 13, 2013, intermediaries, transfer agents, and fund sponsors would have to undergo a time-consuming and costly process to upgrade and retool systems throughout the MMF transaction flow process to accommodate the floating NAV. The redemption limit

[11] *See Money Market Fund Reform; Final Rule*, 75 Fed. Reg. 10060 at 10077 (Mar. 4, 2010) ("Taking into account the comments and after further consideration, we have not identified an effective way at this time to distinguish between types of money market funds to achieve our purpose.").

[12] Release at 36858.

would add an additional layer of complexity to each individual system, even where a MMF sells shares directly to investors, and would require a level of intricate, coordinated monitoring *across* systems that may prove impossible to implement where a MMF is not the direct seller of shares to an investor.

Even where a MMF offers shares directly to investors, the redemption limit will be extremely difficult to implement, monitor, and enforce on a systems level. There are a variety of proprietary software systems involved at each level of the transaction process and by each entity involved in the MMF transaction process that would require updating to accept and accommodate a redemption limit. Each software system in the transaction flow would need to be equipped with the functionality described below, because the point at which the redemption limit would be enforced would vary based on which entity holds the shareholder's account information on its system. Even where funds offer shares directly to investors, software would need to be upgraded to have the capability to:

- Alert shareholders to the daily redemption limit;
- Monitor and enforce redemption limits on certain MMFs and not others;
- Monitor and enforce redemption limits on some shareholders and not others (*i.e.*, not on omnibus accounts);
- Timestamp and record all aggregate trade information over the course of the day and reject requests in excess of the redemption limit;
- Monitor redemption activity by a single shareholder through multiple sources, when, for example:
    - A single shareholder may hold multiple accounts in different capacities (such as individual, joint tenancy, and trust);
    - A single shareholder may hold a MMF's shares through accounts at multiple intermediaries and/or directly through a fund;
- Determine how to process transactions that would cause a shareholder to exceed the redemption limit on a given business day (whether to reject the entire transaction as "not in good order" or to process the amount of the transaction that does not exceed the limit); and
- Determine how to handle redemptions in excess of the redemption limit by a shareholder through multiple capacities (*e.g.*, on a single day, a redemption of $500,000 from an individual account and a redemption of $700,000 from an account held as a joint tenancy).

Developing the functionality to determine the shareholder of record on a real-time basis, to confirm that the redemption request (potentially when aggregated with other requests already fulfilled) does not exceed the daily limit, and to confirm that the request does not implicate accounts held in other capacities would be particularly difficult.

Even if systems could be upgraded to accommodate a daily redemption limit, the limit's imposition would create significant processing delays and increase transaction fails, settlement errors, and counterparty default risk associated with transactions involving MMFs.

In addition to software upgrades, intermediaries, fund sponsors, and transfer agents would also need to retrain their staffs to accommodate shareholder transaction requests given by phone, to operate their updated software platform, and to address any questions or problems shareholders may have with the new platform.

Unless further guidance is forthcoming from the Commission, the limit would also place intermediaries, transfer agents, and fund sponsors in the position of making investment decisions on behalf of shareholders where the limit is triggered. For example, systems would need to have protocols in place in advance regarding whether to process a portion of the transaction or reject it its entirety, and if the former, what portion, and from what account, to process. These situations could become quite complex, such as when a shareholder requests a redemption of $1.1 million and the system must determine whether to either reject the order in its entirety or process the amount that does not exceed the redemption limit; or when a shareholder submits two redemption requests of $500,000 and $600,000 on the same business day, neither of which exceed the redemption limit on its own, and the system must determine what amount to process and from which account.

In order to avoid making decisions on behalf of shareholders to the greatest extent possible when these situations arise, fund sponsors or their transfer agents would likely wish to contact a shareholder of record in the event of a redemption request in excess of the $1 million limit to determine if an alternate course of action is available or necessary to meet the shareholder's liquidity need. This effort would require that, on a very short-term basis, the fund sponsor or transfer agent identify the shareholder of record, determine which redemption constitutes the excessive redemption request, contact the shareholder to determine instructions, and process the redemption as requested by the shareholder and in compliance with the limit. The result would be further processing delays, increased transaction fails and settlement errors, and increased counterparty default risk.

The redemption limit may create an insurmountable challenge of coordination where it would require fund sponsors and intermediaries to monitor daily shareholder redemptions across multiple systems. The Release's redemption limit also presents particular difficulties where intermediaries, fund sponsors, and transfer agents would need to coordinate monitoring of redemption activity across multiple systems. Indeed, this operational challenge could lead to a significant decrease in the offering of omnibus accounts in the retail context.

The Release states that "[b]ecause omnibus accounts can represent hundreds or thousands of beneficial owners and their transactions, they would often have daily activity that exceeds this limit. This combined activity would result in omnibus accounts often having daily redemptions that exceed the limit even though no one beneficial owner's transaction exceeds the limit."[13] In recognition of this fact, the Release would allow a fund to process the transactions of an omnibus account holder that are in excess of the $1 million daily limit if the omnibus account holder "similarly restricts each beneficial owner in the omnibus account to no more than $1,000,000 in daily redemptions."[14] The fund sponsor would need to have "policies and procedures" in place that are "reasonably designed to allow the conclusion that the omnibus account holder does not permit any beneficial owner [to] 'directly or indirectly' redeem[] more than $1,000,000 in a single day."[15]

But the Release's suggestion that omnibus accounts can utilize the retail exemption on a "look through" basis reflects a lack of appreciation for the enormous technical difficulties that would make it extremely difficult to implement and monitor. Fundamentally, each intermediary and transfer agent's trading system would need to have all the functionality described above, and also the ability to monitor and enforce the redemption limit *across* each trading system. At a minimum, this would require developing the functionality to disaggregate omnibus account information to determine the beneficial owner of shares, to coordinate the collection of all aggregate daily trade information from the systems of each intermediary through which the beneficial owner owns shares, and to confirm that the redemption request does not cause the beneficial owner to exceed the daily redemption limit. This costly, time-consuming, and burdensome monitoring process would severely limit the benefits of aggregating individual transactions into omnibus trades in the first place.

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[13] *Id.* at 36860-61.

[14] *Id.* at 36861.

[15] *Id.*

Moreover, the Release provides little guidance as to what "policies and procedures" MMFs should put into place to monitor the activities of omnibus account holders, and how often and to what extent MMFs must review their activities. Instead, the Release states that the Commission would "allow funds to manage these relations in whatever way that best suits their circumstances."[16] Given that MMFs ultimately will be responsible for compliance with the daily redemption limit, and that the Commission has provided so little guidance regarding what constitutes an acceptable compliance program, MMFs may be hesitant to rely upon the intermediaries that do continue to offer clients access to retail MMFs through omnibus accounts to undertake this compliance obligation, for which MMFs ultimately would be responsible. The result likely would be extensive duplication in monitoring arrangements at significant cost, and a time-consuming and expensive process of entering into explicit agreements with each omnibus account holder to govern the compliance obligation.

Intermediaries are unlikely to shoulder the monitoring burden the Release's redemption limit would place on them. More fundamentally, in order for the Commission's "look through" approach to work, omnibus account holders would have to be willing to undertake the expense and burden of policing their customers' redemption activity on each fund sponsor's behalf. Unless the Commission makes the "look through" mandatory for intermediaries, we believe many will have no incentive to undertake these costs and burdens. In fact, trust accounting departments that are omnibus account holders are already writing the Commission to state that their systems are not equipped to handle a daily redemption limit and that a product with a redemption limit will not fit their clients' need for same day liquidity.[17] In all likelihood, many omnibus account holders would forgo the expense of upgrading systems to support a product that will no longer meet their clients' need and would simply cease to offer MMFs as an option to clients.

Sponsors of sweep vehicles also would likely shift away from MMF products that contain a redemption limit. Sweep vehicles aggregate trade activity based on the existing investment parameters of the underlying accounts. Once the trade activity of the underlying accounts has been netted, the sweep vehicle's sponsor places a transaction reflecting the net activity that

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[16] *Id.*

[17] Letter from MainSource Bank to SEC (Aug. 20, 2013) (available in File No. S7-03-13) ("We have no means of controlling the size (e.g., $ 1 million or less) or frequency of [client] distributions. To do so would add an extra layer of manual surveillance (i.e., cost) to what heretofore have been routine liquidity events for the last 25 years using predictable products with same-day liquidity at par."). *Accord* Letter from Woodlands Bank to SEC (Aug. 20, 2013) (available in File No. S7-03-13).

sweep funds into or out of a MMF, often at the end of the day. Sweep transactions happen on a routine and predictable basis, and much of the activity is automated, or at least predetermined according to investor parameters, and is not the result of an attempt by investors to redeem ahead of declining shareholder value. Sweep transactions routinely exceed $1 million daily, however, and as a result retail MMFs would not meet the needs of sweep vehicle sponsors or their underlying account holders without the costly retooling described above. Rather than undertake the extensive systems upgrades to accommodate a redemption limit on a look through basis (or, for that matter, the extensive systems upgrades to accommodate a floating NAV in prime funds), sweep vehicle sponsors would likely shift to government funds. The result would be to restrict investor choice for no identifiable benefit.

Alternative One would lead to consolidation in the MMF industry, contrary to the Commission's mandate to consider the effect of its rules on competition. Given the complexity of the systems that funds, intermediaries and transfer agents would need to develop, the Commission's proposed rule would create a situation favoring the largest MMF sponsors who have the necessary size and funds to develop these complex and intricate systems, at the expense of new entrants to the MMF market. This consolidation effect would be in addition to the significant consolidation that has already occurred in the MMF industry in the wake of the financial crisis. According to data supplied to Federated by iMoneyNet, the number of MMF firms has dropped from 136 in August 2008 to just 82 in August 2013. Further consolidation of the industry as a result of the redemption limit would be contrary to the Commission's mandate to consider the effect of its rulemaking on competition.

In addition, MMFs that are marketed directly to investors by the sponsor, rather than through intermediaries, would have an operational advantage in monitoring and controlling compliance with the $1 million daily redemption limit. This exemption would create a competitive imbalance favoring direct-marketed MMFs over other MMFs.

(2) Alternative One's $1 million daily redemption limit for certain MMFs is arbitrary and would render these funds unavailable to many investors, including individual investors, engaging in transactions that are large but not driven by an effort to redeem ahead of a declining share value. This would be true even in normal market conditions when there is no threat to the stability of a MMF's share value.

According to the Release, exempting retail investors from the floating NAV is appropriate because –

> [R]etail investors have behaved differently from institutional investors in a crisis, being much less likely to make large redemptions quickly in response to the first sign of market stress. Thus prime money market funds that are limited to retail investors in general have not been subject to the same pressures as institutional or mixed funds.[18]

But the $1 million daily redemption limit does not appropriately distinguish between "retail" investors (assuming by "retail" the Commission is referring to investors who are individuals) and "institutional" investors. Moreover, the redemption limit is not narrowly tailored, as other options such as the temporary suspension of redemptions would be, to limit shareholders only when their activity threatens the fund – *i.e.*, during a crisis – but rather would impact investor liquidity even during normal periods.

Although the Release purports to distinguish between "retail" and "institutional" investors with its $1 million daily redemption limit, there is no single, identifiable characteristic of a "retail" investor that is distinct from an "institutional" shareholder.[19] A $1 million redemption limit, in particular, does not create a meaningful distinction between shareholders. Individual shareholders may have many reasons for redeeming in excess of $1 million, including a change in investment strategy in a 401(k) account, a small business owner meeting payroll in the normal course of business, a quarterly trust payment to a beneficiary, or routine sweeps or

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[18] Release at 36856.

[19] The "retail" vs. "institutional" distinction is a notoriously difficult one that the Commission has wisely avoided in the past. *See Money Market Fund Reform*, 75 Fed. Reg. 10060 at 10077 (Mar. 4, 2010).

other redemption activity by high net worth individuals.[20] In fact, in Federated's experience, shareholders invested in share classes marketed as "retail," the best proxy for individual shareholders currently available, routinely redeem MMF shares in amounts exceeding $1 million.[21] This suggests that Alternative One's redemption limit would fail to meet the needs of many shareholders the Commission would classify as "retail."

Perhaps recognizing the difficulty of distinguishing between retail and institutional shareholders, the Release claims that the daily redemption limit would encourage "self-identification of retail investors," because "institutional investors generally would not be able to tolerate such redemption limits" and would "self-select" into institutional funds.[22] But the Release does not recognize that many individual investors would not be able to take advantage of the "retail" investors despite the fact that they are the intended beneficiaries of the Release's exemption. As discussed in Section (1), the $1 million redemption limit is particularly problematic in the sweeps and omnibus context, where the shareholder of record is the institution but the underlying shareholder controls the investment decision. Transactions in these contexts may exceed the redemption limit on a regular basis, whether due to the settlement of a securities transaction, a change in investment strategy in a 401(k) account, or routine redemption activity by high net worth individuals. Moreover, individual shareholders would be dependent on the intermediary to undertake the expense of upgrading systems to monitor the redemption limit. Those individual investors whose intermediaries do not undertake this burden would lose access retail funds in the sweeps and omnibus context altogether.

Whether the Release's proposed redemption limit distinguishes between investors in an appropriate way or not, as currently written it would function as a far more extreme liquidity gate than necessary. Rather than applying only at times when MMFs may experience heavy redemptions – *i.e.*, during periods of market stress or in the face of declining shareholder value – the redemption limit would operate even during normal periods. Moreover, this redemption limit would not be limited in scope only to the type of shareholder redemptions that could threaten a

[20] Of course, even large investors have similar routine transactions that are not motivated by an effort to redeem ahead of other shareholders.

[21] *See also*, Letter from MainSource Bank to SEC (Aug. 20, 2013) (available in File No. S7-03-13) ("The need for same-day liquidity can arise from a host of factors – e.g. the settlement of a securities transaction, distributions associated with the termination of a trust, a major purchase on behalf of an account or a scheduled quarterly payment of a stipulated amount to a beneficiary). *We have no means of controlling the size (e.g., $ 1 million or less) or frequency of such distributions.*") (emphasis added).

[22] Release at 36858.

MMF. Instead, the daily redemption limit would at all times limit shareholder liquidity. If the Commission continues to be concerned that shareholder redemptions could put pressure on MMFs in times of market stress, the Commission has regulatory options (as discussed in more detail in other comment letters filed on behalf of Federated) that would preserve the utility of MMFs, be far less disruptive to shareholders, and would not create the huge operational and compliance burdens of a floating NAV with a $1 million redemption limit exemption.

(3) The Release's assumption that tax exempt funds inevitably would qualify for the retail exemption, based on their investor base, is simply wrong.

The Release suggests that the "proposed retail money market fund exemption . . . would likely cover most municipal (or tax exempt) funds, because the tax advantages that these funds offer are only enjoyed by individuals and thus most of these funds could continue to offer a stable share price."[23] But as discussed in more detail in a separate letter on behalf of Federated on the issue of tax exempt funds, the Release's claim is incorrect because its assumption that only individuals receive a tax benefit from investing in tax exempt MMFs is incorrect. In fact, corporations, partnerships, trusts, and other entities can enjoy the tax advantages of tax exempt funds, as well as individuals.[24] Institutional share classes represent two-thirds of the assets held in Federated's tax exempt funds as of July 31, 2013. In fact, Federated operates two tax exempt funds offered *primarily* to institutional investors.[25] Many of these institutional shareholders would be unable to operate under a $1 million daily redemption limit, contrary to the Release's assumption.[26]

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[23] Release at 36855.

[24] Tax exempt dividends must be added back to a corporation's adjusted current earnings for purposes of calculating its alternative minimum income tax ("AMT"). However, only 75% of net positive adjusted current earnings are an adjustment for corporate AMT and the maximum rate for AMT is lower than the maximum rate for regular income tax. Thus, corporate AMT reduces, but does not eliminate, the tax benefit of tax exempt dividends for corporations that pay AMT. Corporations paying regular taxes, as well as Subchapter S corporations, partnerships and other businesses that are not subject to corporate taxes, enjoy the same tax benefits as individuals.

[25] Federated is not the only manager of institutional tax exempt funds and share classes. According to iMoneyNet data, as of July 31, 2013, institutional investors accounted for approximately $78.6 billion of the approximately $264 billion held in tax exempt funds. This iMoneyNet data is derived from iMoneyNet Analyzer.

[26] As of May 31, 2013, direct (non-omnibus) accounts holding approximately 87% ($1.024 billion) of the $1.176 billion invested in Federated's tax exempt funds had engaged in at least one redemption of more than $1 million

Footnote continued on next page

As a result, under the Commission's proposal, MMFs would have to choose between two unsatisfactory alternatives: either impose a redemption limit on tax exempt MMFs that would force assets out of the funds, or decline to impose a redemption limit and convert to a floating NAV tax exempt fund, which would drive investors who require stable NAV and stability of principal out of the fund. Surely, the Commission did not intend this result.

If the Commission fails to acknowledge the investor base of tax exempt MMFs, and MMFs are forced to place redemption limits on these funds or adopt a floating NAV (either of which would drive institutional investors out of tax exempt MMFs and into alternative products), the consequences will be particularly severe for state and local government issuers and their citizens. Tax exempt MMFs are the principal buyers of short-term notes issued by states and municipalities, and institutional shareholders are significant investors in these MMFs. As institutional shareholders who value same-day liquidity are not likely to invest directly in state and municipal obligations, the likely outcome of Alternative One would be to increase financing costs for these issuers. We assume this is not the outcome the Commission intended Alternative One to have.

Tax exempt MMFs have been very stable through many market cycles and did not experience large redemptions during the 2008 Financial Crisis. It certainly is not necessary to impose a floating NAV upon them as a means to address large-scale investor redemptions. Federated strongly urges the Commission not to impose a floating NAV requirement or daily redemption limits on tax exempt funds.

Footnote continued from previous page
during the previous 12 months or had a current balance in excess of $1 million. A $1 million redemption limit would therefore affect most of the direct accountholders of Federated's tax exempt funds.

(4) Despite the exemption from the floating NAV, the elimination of the amortized cost method of accounting for government and retail funds would push back settlement times by hours or even overnight, create settlement bottlenecks, increase costs and risks for shareholders, and introduce new risks from potential technology breakdowns and systems failures at pricing vendors, while achieving no regulatory purpose, because shares will ultimately be penny rounded to the same $1.00 per share price.

The Release states that under Alternative One, retail and government MMFs would be prohibited from using amortized cost to value portfolio assets with a maturity in excess of 60 days.[27] Other portfolio assets would have to be valued at a "market-based" valuation (*i.e.*, matrix or mark-to-model valuation), and the NAV would then be rounded to the nearest penny. The Release posits that because "penny rounding alone [is] an equal method of achieving price stability in MMFs," government and retail MMFs would have the benefit of a stable NAV under these circumstances.[28] The Release also rationalizes that because the Commission is proposing to require MMFs to disclose daily share prices with portfolios valued using market factors and applying basis point rounding, stable value funds in any event would have to value their portfolio assets using market factors each day.[29] This is the entirety of the Commission's justification for its pricing proposal for retail and government MMFs – that eliminating the amortized cost method of valuation and permitting only penny rounding will make no difference to stable value MMFs. Given that the "shadow price" of a MMF using the amortized cost method of accounting is the same as the unrounded NAV of a MMF using the penny rounding method of establishing share prices, this proposal would only serve to increase the processing time for purchase and redemption transactions, and the costs and risks of operating a stable value MMF.

In our letter on the floating NAV proposal, we described in detail the time-consuming process of reaching an NAV through mark-to-model pricing – which retail and government MMFs, as well a prime MMFs, likely would have to undertake before penny-rounding the shares

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[27] 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.").

[28] *Id.*

[29] *Id.*

to the $1.00 NAV.[30] Stable value MMFs would not be able to meet shareholder redemption requests throughout the day, as they do now, but would need to batch redemptions at periodic intervals, with prices struck at some point following a shareholder's request and with the delivery of funds to the investor perhaps three or four hours later, or longer.[31] Fund pricing services and fund accountants tell us this would require multiples of current staff and introduce greater risk of errors and, in the end, meaningless variations – if any – in valuations. For government funds, while investors may have the convenience of stable value, they would have the inconvenience of delays up to three to four hours in redemptions, to accommodate the valuation process. In fact, the move would significantly hamper the liquidity of the same-day markets for Treasury and agency securities and repos. The delay in transaction processing would also have a destabilizing impact at the end of the day prior to the Fedwire closing, as the Fedwire likely would have to accommodate a sharp uptick in end-of-day transactions, increasing the risk of fails in the payment systems.

These delays in settlement times would force earlier deadlines for order submission, cause transactions to settle the next business day and make it even harder for a shareholder to coordinate its MMF settlement with the cash transactions to or from which those MMF cash settlement amounts are moving. The delay serves no purpose. It is highly unlikely that the market-based estimate from which stable value funds are penny-rounded will deviate more than .0001 throughout the day, if at all, and in any event the redemption price always will be $1.00 per share. The elimination of the amortized cost method to value MMF shares would create pointless "make work" for retail and government funds, which will be costly, delay- and risk-creating, for no purpose whatsoever. It is not, as the Commission states, an "equal method" of achieving price stability.

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30 Letter from John D. Hawke, Jr. on behalf of Federated Investors to SEC (Sept. 13, 2013) (available in File. No. S7-03-13). In that letter, we explained that the process of striking a "market based" price is time consuming and resource intensive and involves judgments, estimates, and opinions. MMFs typically use independent pricing vendors to obtain "market based" valuations for these instruments, a process that involves comparing these instruments to a homogenous set of instruments in the market to derive a valuation. These are not "mark-to-market" prices, but good faith estimates of the prices at which an instrument might trade. From these valuations, the MMF then calculates an NAV per share, based on the total assets and liabilities of the fund and the number of shares outstanding. The process of arriving at each the "market-based" NAV takes between three to four hours.

31 Today, a stable NAV derived through the amortized cost method of accounting 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.

(5) By leaving government MMFs as the only viable stable value cash management vehicle for institutional investors, the Commission effectively is promoting the ability of the federal government to borrow at the expense of state and local governments and private issuers by funneling additional assets into government MMFs. This "crowding out" is contrary to the Commission's obligation to consider the effects of its rules on competition, market efficiency, and capital formation.

Throughout the Release, the Commission suggests that investors negatively affected by changes in retail or prime funds will always have the option of shifting assets to government funds.[32] Indeed, the Commission appears to excuse a number of the ills created by its proposed changes by suggesting that aggrieved investors could simply move to government funds.[33] As a threshold matter, we do not believe it is appropriate for the Commission enact changes that would lead to a loss of yield for investors with no identifiable benefit. Moreover, government funds may no longer meet the needs of many investors for a low-risk, fully-liquid product if mark-to-model valuation creates the settlement delays and additional risks described above. Several bank intermediaries performing corporate and institutional trust services have told Federated that they are concerned about the impact of a large flow of prime MMF assets onto their own balance sheets or into government MMFs.

In any event, the Commission's suggestion that government funds would absorb assets currently held in prime MMFs generally is consistent with how Federated's clients suggest they would react. As a result of the Commission's proposal, government funds, which currently hold over $921 billion in investor funds, stand to gain billions more as investors seeking a stable NAV and full liquidity reallocate funds.[34] This structural reallocation would come at the cost of a loss

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[32] *See, e.g.*, Release at 36855 ("Similarly, investors who prefer a stable price fund or are unable to invest in a floating NAV fund could choose to invest in government money market funds. These investors could continue to use these money market funds as a cash management tool without incurring any costs or other effects associated with floating NAV investment vehicles.").

[33] Release at 36851 ("[I]nvestors unwilling to bear the risk of a floating NAV would likely move to other products, such as government or retail money market funds (which we propose would be exempt from our floating NAV proposal and permitted to maintain a stable price)."); Release at 36855 ("Investors have frequently noted the benefits of having a stable money market fund option, and exempting government money market funds from a floating NAV would allow us to preserve this option at a minimal risk.").

[34] *Money Market Mutual Fund Assets as of August 29, 2013*, Investment Company Institute (Aug. 29, 2013), http://www.ici.org/research/stats/mmf/mm_08_29_13.

of yield to investors and a loss of credit to the private issuers and state and local governments that depend on MMFs to purchase private commercial paper and public short-term debt securities. We do not believe it is appropriate for the Commission to promote the ability of the Federal government to borrow at the expense of state and local governments and private industry. Indeed, such action would appear to be contrary to the Commission's mandate to consider the effect of its rulemakings on efficiency, competition and capital formation.

Conclusion

Alternative One of the Commission's proposal would be enormously harmful, burdensome, and would result in departures of both institutional and retail investors from MMFs and a shrinkage in MMFs, with collateral consequences to state and local governments and private issuers. The exemptions included in the proposal for the purposes of limiting the effects of the floating NAV requirement on retail and government MMFs do not achieve the Commission's intended goal. If the Commission were to adopt Alternative One, its staggering operational burdens, systemic effects, and high costs would be incurred for no identifiable benefit. We urge the Commission not to adopt Alternative One. We understand that a number of commenters have raised concerns regarding the ability to implement Alternative One's daily redemption limit and may propose alternative ways to separate "retail" from "institutional" MMFs. Of course, we anticipate that if the Commission makes material changes to Alternative One, the Commission will issue an amended proposed rule to provide interested parties the opportunity to review the operational implications of any alternative approach. We separately are commenting on proposed modifications to the Commission's Alternative Two, which we believe has the potential to more fully address the Commission's concerns.

Sincerely,

John D. Hawke, Jr.

John D. Hawke, Jr.