Federated Investors, Inc.
Federated Investors Tower
1001 Liberty Avenue
Pittsburgh, PA 15222-3779

412-288-1900 Phone
www.federatedinvestors.com

Federated

WORLD-CLASS INVESTMENT MANAGER®

September 16, 2013

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

Re: Money Market Fund Reform; Amendments to Form PF, File Number S7-03-13 —Comments Regarding the Proposed Regulation of Tax-Exempt Money Market Funds

Dear Ms. Murphy:

This is one of a series of letters from Federated Investors, Inc. ("Federated") regarding the various money market reform proposals made by the Securities and Exchange Commission (the "Commission") in Investment Company Act Release No. 30551 (the "Reform Proposal").[1] This letter addresses Federated's comments regarding the application of the Reform Proposal to tax exempt funds, as defined in Proposed Rule 2a-7(a)(25).[2] The comments made herein relate to the special characteristics of tax exempt funds and of the short-term municipal market.

1. INTRODUCTION

Tax exempt funds have unique characteristics not reflected in the Reform Proposal. First, tax exempt funds offer a unique opportunity to earn tax-exempt income on cash balances, as there are no tax-exempt bank accounts or repurchase agreements. Second, tax exempt funds hold a majority of their portfolio in variable rate demand obligations ("VRDOs") subject to demand features from high quality banks and dealers, which make tax exempt funds less dependent on market liquidity than prime, or even government, money market funds ("MMFs"). Third, federal tax laws constrain the capacity of states and municipalities to issue short-term notes, and the supply of VRDOs depends on the number of eligible demand feature providers, their willingness

[1] 78 Fed. Reg. 36834 (June 19, 2013). An overview of Federated's comments is provided in its initial comment letter on the Proposed Reforms, Reform Proposal, John D. Hawke, Jr., Arnold and Porter, LLP on behalf of Federated Investors, Washington (Sept. 11, 2013), http://www.sec.gov/comments/s7-03-13/s70313-107.pdf.

[2] For purposes of these comments, "Proposed Rule 2a-7" refers to the Alternative 2 version of Rule 2a-7 that begins on page 37005 of the Reform Proposal, unless the context refers to Alternative 1. Proposed Rule 2a-7 defines a 'tax exempt fund" as "any money market fund that holds itself out as distributing income exempt from regular Federal income tax" and a "single state fund as "a tax exempt fund that holds itself out as seeking to maximize the amount of its distributed income that is exempt from the income taxes or other taxes on investments of a particular State and, where applicable, subdivisions thereof." For convenience, this letter incorporates the other terms defined in Proposed Rule 2a-7, and will refer to paragraphs of Proposed Rule 2a-7, even if such terms are already defined or provisions are already included in the current version of Rule 2a-7.

and capacity to provide demand features and the willingness of issuers to fund projects at variable rather than fixed rates. These market constraints cause regulations limiting investments to have a greater impact on tax exempt funds than on prime or government MMFs.

When these unique features of tax exempt funds are taken into account, we expect the Commission will agree that:

- Neither Alternative 1 nor Alternative 2 should apply to tax exempt funds;
- The so-called "25% basket" for providers of guarantees and demand features should be retained for tax exempt funds;
- Tax exempt funds should not be subjected to the 10% daily liquid asset requirement.

Of course, Federated steadfastly opposes Alternative 1 and the elimination of the 25% basket for all MMFs. Federated also opposes requiring MMFs to maintain a stable value using the penny rounding rather than the amortized cost method. As this requirement would apply to any stable value MMF, it will be addressed in a separate letter. However, should the Commission eventually decide to adopt these reforms, they should not extend beyond prime MMFs.

2. ALTERNATIVE 1 SHOULD NOT APPLY TO TAX EXEMPT FUNDS

Alternative 1 of the Reform Proposal would require a MMF (other than a government MMF) to either: (a) limit the maximum amount a shareholder could redeem on any day to $1 million (impose a "daily redemption cap"), or else (b) calculate its net asset value per share ("NAV") in the same manner as other mutual funds, except that a MMF would round its NAV to the nearest basis point (calculate share prices using a "floating NAV"). In her statement regarding the Reform Proposal, Chair White emphasized that "This floating NAV proposal specifically targets the funds where the problems during the financial crisis occurred: *institutional, prime money market funds.*"[3] Unfortunately, Alternative 1 overshoots this specific target by treating tax exempt funds the same as prime MMFs. None of the problems during the financial crisis occurred in tax exempt funds, whether "institutional" or "retail." The Commission should therefore exclude tax exempt funds to the same extent as government MMFs from the requirement to either impose a daily redemption cap or calculate a floating NAV.

The Commission's assertion that tax exempt funds did not experience the same redemption pressures as prime MMFs during the financial crisis is well founded. According to data from iMoneyNet, during the crisis week of September 16th through the 23rd, redemptions from "institutional" tax exempt funds were not even half (on a percentage basis) of redemptions from institutional first tier prime MMFs. "Institutional" classes of single state funds lost approximately $2.5 billion (7.4%) during this week and "institutional" classes of other tax exempt funds lost $15.1 billion (8.5%), while "institutional" classes of prime first tier MMFs lost $263.1 billion

[3] Opening Statement of Chair Mary Jo White at the SEC Open Meeting on June 5, 2013, http://www.sec.gov/news/speech/2013/spch060513mjw.htm. [Emphasis added.]

(21.5%). No one has reported any tax exempt funds that required any liquidity support to cover these redemptions.

2.1 Problems with the "Institutional"/Retail" Division in Alternative 1

In a separate comment letter, Federated discusses in some detail the problems with the Commission's proposal to have "institutional" investors self-select out of stable value MMFs by imposing a $1 million daily redemption cap. Fundamentally, this approach will only distinguish shareholders with larger cash flows from those with smaller cash flows. There is no evidence that it will distinguish "faster-moving" from "slower-moving" shareholders, which is the purported rationale for the daily redemption cap.

Although Federated does not believe that any definition of "institutional" or "retail" is helpful in gauging the speed at which a shareholder might redeem from a MMF during a financial crisis, current classifications of "institutional" share classes probably provide a rough, conservative, approximation of the shareholders who would withdraw their cash from a MMF that imposed a $1 million daily redemption cap. In other words, statistics maintained by the iMoneyNet and others that treat certain MMFs and share classes as "institutional" can be used to estimate the assets that shareholders are likely to remove from stable NAV MMFs following adoption of a daily redemption cap. This estimate would be conservative because an analysis of Federated's direct (non-omnibus) accounts shows that many MMF shareholders classified by the iMoneyNet as "retail" have engaged in redemptions of more than $1 million during the past twelve months. Thus, adoption of Alternative 1 will probably result in a substantial reduction in "retail" as well as "institutional" assets.

2.2 There Are "Institutional" Tax Exempt Fund Shareholders

Apparently, the Commission did not intend for many tax exempt funds to calculate a floating NAV as a result of Alternative 1. Instead, the Commission believed 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."[4] The Reform Proposal does not cite any authority for the claim that "the tax advantages that these funds offer are only enjoyed by individuals," but the claim is incorrect: corporations, partnerships, trusts and other entities can enjoy the tax advantages of tax exempt funds, as well as individuals.[5] These institutional share-

[4] Reform Proposal at 36855.

[5] 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.

With respect to small businesses that could no longer invest cash in tax exempt funds as a result of the daily redemption cap, the Commission must factor the additional taxes that would be paid by these businesses into the cost-benefit analysis required under the Small Business Regulatory Enforcement Fairness Act of 1996. The holders may not be able to operate under a daily redemption cap, which means the tax exempt funds in which they currently invest could no longer continue to offer a stable share price under Alternative 1, contrary to the Commission's apparent intent.

"Institutional" share classes represent two-thirds of the assets held in Federated's tax exempt funds on July 31, 2013, and the proposed daily redemption cap would affect the bulk of direct (non-omnibus) accounts in Federated's tax exempt funds. As of May 31, 2013, these direct accounts held over $1.176 billion. Accounts holding approximately $1.024 billion (87%) of these assets had either engaged in at least one redemption of more than $1 million during the previous 12 months or had a current balance in excess of $1 million. Using "know-your-customer" information, Federated has identified another $2.1 billion of institutional assets held in its tax exempt funds' omnibus accounts. This $2.1 billion includes only accountholders that Federated can definitively identify as institutions; there were certainly additional institutional accountholders in these omnibus accounts. A daily redemption cap would therefore affect most of Federated's direct accountholders and many omnibus accountholders.

In fact, Federated operates two tax exempt funds offered primarily to institutional investors. Because omnibus accounts account for approximately 90% of these funds' assets, Federated cannot determine the exact composition of shareholders in these accounts. Federated can confirm, however, that institutions dominate the remaining 10% of assets held in direct accounts. As of May 31, 2013, these funds had over 250 direct accounts (which held approximately $900 million) from corporations, indenture trustees, escrow agents, securities lending agents and other institutional investors. These funds also had over 180 direct retail accounts (which held approximately $90 million), of which over 70% of the assets were held in accounts with balances in excess of $1 million. Another $1.556 billion was held in omnibus accounts by institutions identified using "know-your-customer" information. Clearly, these two funds could not continue to retain assets if they imposed a daily redemption cap, and would have to convert to a floating NAV under Alternative 1.

Federated is not the only manager of "institutional" tax exempt funds and share classes. iMoneyNet data shows that, as of July 31, 2013, institutional shareholders accounted for approximately $78.6 billion (29.8%) of the approximately $264 billion held in tax exempt funds.[6] This relatively low amount and percentage of assets reflects the extraordinarily low rates paid on short-term tax-exempt obligations since the financial crisis. During normal market conditions, institutional shareholders make up a larger percentage of tax exempt fund assets. The six-year period from 2004 through 2009 reflects a more normal utilization of tax exempt funds by institutions, during which period institutional shareholders consistently contributed from 39% to 41% of the year-end assets held in tax exempt funds. Year-end assets held in "institutional" tax exempt funds during this period averaged $155.8 billion.[7]

Commission must also factor into this analysis the increased financing costs for small municipalities discussed in Section 2.4 below.

[6] All iMoneyNet information is derived from iMoneyNet Analyzer.

[7] Percentages and averages were derived from Table 39 of the Investment Company Institute's Investment Company Fact Book 2013.

Thus, contrary to the assertions of the Reform Proposal, the "retail exception" will not exempt a substantial portion of the assets held in tax exempt funds from the floating NAV requirement of Alternative 1.

2.3 Institutional Shareholders Provide Significant Capital to State and Local Governments

Shareholders in "institutional" tax exempt funds have the same objective as shareholders in institutional prime and government MMFs—daily liquidity at a stable value. Their preference for tax exempt income explains why these shareholders choose to invest in tax exempt funds rather than other types of MMFs, but it is not the reason they choose to invest in MMFs rather than other mutual funds. Thus, the Commission should anticipate that institutional shareholders in tax exempt funds would respond to Alternative 1 in the same manner as institutional shareholders in prime MMFs. As has been documented in Federated's comment letter on Alternative 1, the overwhelming response of these shareholders will be to move their cash to government MMFs, bank deposits and alternative cash investments.

A reduction in assets held in tax exempt funds would seriously affect the finances of state and local governments.[8] Tax exempt funds are the principal buyers of short-term notes issued by states and municipalities. The Bond Buyer reported that states and municipalities issued $59.57 billion of tax-exempt short-term notes in 2011.[9] The RSFI Study found that, on March 31, 2012, MMFs other than prime and treasury funds held $55.56 billion of municipal debt other than VRDOs.[10] As it would be extremely uncommon for government MMFs to hold tax-exempt municipal debt, tax exempt funds must have held all or nearly all of this debt. While some of the $55.56 billion consisted of obligations other than short-term notes (such as serial bonds and long-term bonds within one year of their final maturity), after VRDOs, short-term notes are by far the largest portfolio holdings of tax exempt funds.[11] These numbers firmly support the conclusion that tax exempt funds currently provide most of the short-term tax-exempt funding to state and local governments.

According to iMoneyNet data, institutional shareholders held 34.4% of the assets invested in tax exempt funds as of April 2, 2012. Assuming that "institutional" tax exempt funds

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[8] This is why members of Congress who were former state and local officials have written to the Commission to express concerns about the potential impact of MMF reforms on state and local governments. *See*, Letter from 33 Members of Congress to the Commission (May 1, 2012), http://www.preservemoneymarketfunds.org/wpcontent/uploads/20 12/05/Congress _Letter _to_ SEC _5-1-12 _133596585ll.pdf, and Letter from 20 U.S. Senators to the Commission (July 25, 2012).

[9] The Bond Buyer's 2012 in Statistics Annual Review at 3A, http://www.bondbuyer.com/pdfs/BB-2012-stats-supp.pdf.

[10] RSFI Study at Table 7. The Commission would have a clearer understanding of the significance of "institutional" tax exempt funds to short-term municipal financing if it reviewed the holdings of tax-exempt funds reported in the first Form N-MFPs filed at the beginning of January 2011. At the time covered in these initial reports, the Federal Reserve policy of ultra-low interest rates had been in effect for only two years, and assets held in "institutional" tax exempt funds were 50% higher than they are today.

[11] iMoneyNet, Money Fund Report at 27 (June 21, 2013) shows General Market Notes (at 15% of portfolio holdings), as the next largest portfolio holdings after Demand Notes (at 77%).

hold the same proportion of short-term notes as other tax exempt funds,[12] these shareholders would have accounted for nearly $19 billion of the $55.56 billion of short-term obligations held by these funds. This provides a conservative "ballpark" figure of the potential impact of Alternative 1 on short-term funding for state and local governments. The actual impact would probably be much larger, insofar as: (a) a substantial amount of cash will probably be removed from retail as well as institutional share classes in response to the $1 million daily redemption cap and (b) institutional share classes represent 40% of the tax exempt fund assets during normal market conditions.

Of course, the Commission has the data necessary to calculate the potential impact of Alternative 1 on funding from state and local governments more precisely. Form N-MFP provides the assets attributable to each share class offered by a tax exempt fund. (iMoneyNet could provide the Commission's staff with a list of which share classes have been classified as institutional.) Form N-MFP also provides the month-end portfolio of every tax exempt fund. The Commission's staff could use this data and information available on Bloomberg to identify all of the notes held by tax exempt funds that were issued with an original term of 397-days or less.[13] The staff could derive the amount of short-term municipal funding attributable to institutional shareholders from this data. Such an analysis would be critical to the Commission's assessment of the potential effect of Alternative 1 on capital formation and efficiency in the market for short-term municipal obligations.

2.4 Alternative 1 Will Significantly Increase Funding Costs for Municipal Issuers of Short-Term Notes

No one should expect a significant portion of any cash withdrawn from tax exempt funds as a result of Alternative 1 to be reinvested directly in municipal obligations. States and municipalities issue tax-exempt short-term notes with original maturities from four months to (most commonly) one year. Shorter maturities are not practical, as the issuer typically would not receive the taxes or other revenues needed to repay the notes until later in its fiscal year. Institutions investing cash directly in the money market generally invest on an overnight basis in order to maintain liquidity. Institutions might extend a portion of their cash balances out for a week or perhaps a month, but not for any longer-term. Thus, cash managers cannot be expected to invest directly in municipal notes.

Moreover, municipal issuers cannot freely substitute long-term for short-term funding. As just noted, most short-term municipal notes are issued in anticipation of taxes or other revenues that will be received later in the year. Taxes and revenues not used to repay obligations or current expenses would be subject to federal regulations restricting arbitrage of bond proceeds. A

[12] Federated's two "institutional" tax exempt funds currently hold a higher percentage of their assets in short-term notes than Federated's other tax exempt funds.

[13] Large note issuances (e.g., notes issued by states such as California and Texas) are frequently converted into tender option bonds with weekly demand features, so that tax exempt funds can purchase the notes without exceeding Rule 2a-7's limits on weighted average maturity. The staff will therefore need to review the reported VRDOs, as well as other municipal obligations, to obtain an accurate estimate of the amount of short-term funding provided by tax exempt funds.

municipality that funded working capital by issuing long-term bonds would thus find itself paying interest for funding it would not need (after it has collected the taxes or revenues) and rebating to the federal government any earnings from the investment of such excess funding.

In fact, municipalities often issue short-term obligations to reduce the cost of long-term financing. As their name suggests, bond anticipation notes ("BANs") are short-term notes (normally with one-year terms) issued in anticipation of the issuance of long-term bonds. Municipalities use BANs to fund the costs of long-term projects. BANs help to lower a project's financing cost by (a) allowing the municipality to borrow only the amount needed for the current phase of the project and (b) paying a much lower interest rate than the municipality would pay on long-term bonds. If municipalities did not have this alternative form of funding, they would have to borrow the entire cost of the project up front, regardless of whether market conditions favor long-term funding, and account for and rebate to the federal government any excess earnings on invested bond proceeds. This would substantially increase the cost of capital projects and, as a result, the taxes and fees charged by municipalities.

Size is another factor that militates against the placement of short-term municipal obligations directly with investors. During the twelve months ended June 30, 2013 (which corresponds to the fiscal year of most municipalities), Federated's tax exempt funds purchased short-term notes issued by 254 state or municipal entities, of which 196 were in principal amounts of less than $10 million. The median note had a principal amount of approximately $4.4 million, which indicates that relatively small entities issued most of these notes. Prime MMFs will not spend time reviewing such small deals. Further, those who regularly invest in taxable obligations are not familiar with the specific security features and structures required in each state, or with the budgeting and funding processes that govern, and often times drive, the fundamental credit picture of a municipal issuer. This will prevent such investors from stepping into fill the gaps created by a loss of funding from tax exempt funds.

Prior to the introduction of tax exempt funds, local governments and their instrumentalities relied on banks for short-term funding. Banks charge taxable rates for these loans, generally at the prime rate or higher. As the prime rate is normally more than 300 basis points above the rates paid for funding from tax exempt funds, if Alternative 1 forces municipalities to finance working capital through bank loans, it would dramatically increase their funding costs. In concrete terms, if 16 California school districts had to borrow $27 million from a bank instead of selling $27 million of 2013-2014 Senior Series B California School Cash Reserve Program Authority Notes to tax exempt funds, their annual borrowing costs would have increased from $54,000 to over $864,000. On a national level, based on our estimated $19 billion of short-term municipal funding provided by institutional shareholders in March 2012, the cost of borrowing these funds from banks would have been $570 million higher than the interest paid by these state and local governments to tax exempt funds.

2.5 Alternative 1 Could Lead to the Elimination of Single State Funds

As noted before, Federated's single state funds offer both institutional and retail share classes. With the possible exception of California and New York, market forces make it difficult for a fund manager to offer two separate single state funds for an individual. The recent merger or liquidation of a large number of single state funds due to diminished assets demonstrates the reduced viability of these funds.[14]

Thus, managers will not be able to respond to Alternative 1 by offering both a floating NAV single state fund and another single state fund with a daily redemption cap. Given that we do not expect institutional investors to use fluctuating NAV MMFs, Federated anticipates that most single state funds will elect to impose a daily redemption cap. The loss of assets from investors who cannot operate under a daily redemption cap may leave these single state funds with insufficient assets to operate efficiently, in which case the funds will be closed. Federated estimates that it would close as many as eight of its fourteen single state funds if they could no longer offer an institutional share class. Thus, Alternative 1 is likely to lead to the elimination of single state funds for retail as well as institutional shareholders, which will reduce capital formation and market efficiency.

3. ALTERNATIVE 2 SHOULD NOT APPLY TO TAX EXEMPT FUNDS

Although Federated generally supports Alternative 2 for prime MMFs, subject to important modifications, Federated does not believe that the alternative would be appropriate for tax exempt funds. In general, Alternative 2 would require a prime MMF or tax exempt fund to implement a 2% liquidity fee if, at the end of any business day, the MMF's weekly liquid assets were less than 15% of its total assets, unless the fund's board of directors or trustees (its "Board") determines that imposing the fee is not in the best interest of the fund. Alternative 2 would also give the Board the option under these circumstances of (a) imposing a lower liquidity fee or (b) suspending redemptions for a period not to exceed 30 days, if it concludes that either action is in the best interest of the fund. The Board could not suspend redemptions for more than 30 days in any 90-day period, but could impose a liquidity fee indefinitely.

Like a government MMF,[15] a tax exempt fund is unlikely to hold less than 15% of its total assets in weekly liquid assets. Since June 2010, Federated's tax exempt funds' weekly liquid assets have *averaged* 80% of their total assets.[16] The lowest weekly liquid asset holdings of any Federated single state fund during the period was 52.6% and the lowest of any Federated national tax exempt fund was 60.1%. In other words, since the 2010 amendments took effect, no Federated national tax exempt fund has failed to hold less than *twice* the required percentage of weekly liquid assets and weekly liquidity assets have constituted at least a majority of the assets of every Federated single state fund.

[14] According to data from iMoneyNet, the number of single state funds has declined from 148 at the end of 2007 to 99 at the end of 2012.

[15] We exclude Treasury MMFs from government MMFs for purposes of this discussion, as a fund that invests entirely in Treasury securities and repurchase agreements collateralized fully by Treasury securities would have 100% of its assets held in weekly liquid assets.

[16] Based on the amount of weekly liquid assets held by each Federated tax exempt fund on each day during the period. MMFs were not required to monitor weekly liquid assets before June 2010, so Federated does not have readily available data for earlier periods. Federated did not change the amount of liquidity maintained by its tax exempt funds in response to the 2010 amendments, however, so we believe the percentage of weekly liquid assets would have been the same for earlier periods.

Given the limited supply of other types of tax-exempt obligations with maturities of less than sixty days, Federated expects that other tax exempt funds maintain comparable levels of weekly VRDOs. This makes tax exempt funds more like government MMFs than like prime MMFs. Figure 7 of the RSFI Study showed that the *lowest* percentage of weekly liquid assets held by *any* Federated tax exempt fund exceeded the percentage of weekly liquid assets held by 75% of prime MMFs. Although the RSFI study did not include weekly liquid asset holdings of government MMFs, with average holdings of 80% in tax exempt funds, government MMFs could not hold a meaningfully higher percentage of weekly liquid assets.

Demand features back all of the weekly liquid assets held by Federated's tax exempt funds. This also makes tax exempt funds more like government MMFs in that, even during a financial crisis, tax exempt funds can recover the entire amortized cost value of most of their portfolio. Tax exempt funds are thus less likely than other MMFs to incur losses when disposing of portfolio securities to raise liquidity to meet heavy redemptions. Finally, like government MMFs, tax exempt funds did not experience the same problems as prime MMFs during the financial crisis.

The Commission might think that, as a tax exempt fund is unlikely to ever meet the conditions for imposing a liquidity fees or temporarily suspending redemptions, no harm could result from leaving these options open for a tax exempt fund's Board. As explained in Federated's comment letter on Alternative 2, we have found that shareholders are very sensitive to even a remote risk that they may lose access to the full amount of their account balances. If there is no realistic prospect of a tax exempt fund ever imposing a liquidity fee or temporarily suspending redemptions, then including tax exempt funds in Alternative 2 will only raise unwarranted concerns for their shareholders.

4. TAX EXEMPT FUNDS NEED THE 25% BASKET FOR THEIR NORMAL OPERATIONS

The Reform Proposal would eliminate the exception to Rule 2a-7's diversification requirements for providers of guarantees and demand features known as the "25% basket." Generally, Rule 2a-7 prohibits a MMF from acquiring a security subject to a guarantee or demand feature (an "Enhanced Security") if the acquisition would result in the MMF holding more than 10% of its total assets in securities issued by or subject to guarantees and demand features from the provider of the guarantee or demand feature (the "Enhancement Provider"). The 25% basket allows a MMF to acquire first tier Enhanced Securities in excess of this 10% limit, provided: (a) the Enhancement Provider is not an affiliate of the issuer of the Enhanced Security, and (b) the acquisition would not result in more than 25% of the fund's total assets being invested in securities issued by or subject to guarantees or demand features from Enhancement Providers that exceed the 10% limit.

Without the 25% basket, a tax exempt fund could not invest more than 10% of its total assets in Enhanced Securities subject to guarantees or demand features from a bank or bond insurance company. (Banks and bond insurance companies cannot issue tax-exempt securities, so tax exempt funds do not own any direct obligations of these entities.) Complying with a strict 10% limitation has two adverse consequences for tax exempt funds. First, it may force a tax exempt fund to invest in Enhanced Securities with marginally higher credit risks once the fund reaches the limit for a stronger Enhancement Provider. Second, it may reduce the fund's liquidity, if the only demand features available in the market are from Enhancement Providers that have already reached their limit.

For these reasons, Federated's tax exempt funds frequently rely on the 25% basket. In June 2013, 16 of Federated's 20 tax exempt funds were utilizing the 25% basket, including 12 of 14 single state funds. All of the Enhancement Providers in the 25% basket were banks providing demand features for VRDOs. As these figures indicate, the 25% basket is particularly important for single state funds, which have a more limited selection of Enhancement Providers than national tax exempt funds.

Federated believes that other tax exempt fund managers utilize the 25% basket with similar frequencies. Although the Reform Proposal sites a Commission staff study which concluded that elimination of the 25% percent basket "would have little impact on the majority of money market funds, which do not make use of the twenty- five percent basket, and would likely have a minimal impact on those funds that do,"[17] this conclusion is based on a flawed analysis. First, the analysis included government MMFs in calculating the percentage of funds that utilized the 25% basket. Rule 2a-7 excludes securities guaranteed by the U.S. government and its instrumentalities from its diversification limitations. Hence, government MMFs never need to rely on the 25% basket, which explains why none did so on February 28. 2013.[18] The Reform Proposal did not include the data underlying the staff's study, so we cannot calculate the exact impact of including government MMFs. However, the 2013 Investment Company Fact Book reports 580 MMFs at the end of 2012 (slightly higher than the 574 funds implied by the staff's results), of which 158 were government MMFs. If we divide the 109 MMFs the staff identified as needing to use the 25% basket by the remaining non-government funds, the result is more than a quarter of the funds utilizing the 25% basket.

Second, given the high number of Federated tax exempt funds that utilize the 25% on a regular basis, we expect that the bulk of the 109 funds utilizing the 25% basket were tax exempt funds. According to the 2013 Investment Company Fact Book, there were 180 tax exempt funds at the end of 2012. Thus, if at least 91 of the 109 fund identified by the staff were tax exempt funds, then a majority of tax exempt funds utilized the 25% basket on February 28, 2013. The Fact Book does not provide data for single state funds, but, in light of the constrained markets in which single state funds operate, we would be surprised if a closer examination of the staff's data failed to show more than a majority these funds utilizing the 25% basket.

Third, the Commission's staff concluded that elimination of the 25% basket would not affect the yield of tax exempt funds based on a comparison of the yields of funds that used the 25% basket with those that did not. This conclusion assumes that funds could replace the securities guaranteed or subject to a demand feature from an Enhancement Provider in the 25% basket with the securities held by the funds that do not utilize the basket. This is not how the market for

[17] Reform Proposal at 36961-62.

[18] See Reform Proposal at n. 892.

short-term municipal securities operates. The municipal market is not like the public stock market: a fund cannot go to an exchange and purchase any VRDO it chooses. It is more reasonable to assume that tax exempt funds use the 25% basket because they need it to remain fully invested. This means that elimination of the 25% basket is likely to decrease both the yield and liquidity of tax exempt funds.

Finally, the staff's analysis observed that securities counting towards the 25% basket represented, on average, only 13.9% of the fund's total assets. This may be a product of the mathematics underlying the 25% basket. Mathematically, the 25% basket holds only two Enhancement Providers. (If a third Enhancement Provider's securities exceeded 10%, then the fund would need to exclude more than 30% of its total assets from the 10% diversification limit.) If a fund invests the full 25% in two Enhancement Providers, the fund would have only 5% of its total assets invested in excess of the 10% limit. Even if a fund has securities from only one Enhancement Provider in the 25% basket, it cannot invest more than 14% (in round numbers) in this Enhancement Provider and retain the option of adding a second Enhancement Provider to the 25% basket. If most funds either use the 25% basket for two Enhancement Providers or seek to maintain the option of adding a second Enhancement Provider to the basket, then we would expect the results found in the staff's analysis. Regardless of the reasons, having to invest 4% of a fund's assets in a marginally weaker Enhancement Provider, or (more likely) having to leave the assets uninvested because securities from other Enhancement Providers are not available, would result in a nontrivial increase in the fund's credit risks or decrease in the fund's yield.

The Reform Proposal discusses at some length the financial problems of monoline bond insurers that occurred during the financial crisis, and suggests that this is evidence that investors would benefit from greater diversification with respect to guarantors.[19] This analysis misses the point that these financial problems did not have any adverse effects on tax exempt funds or their shareholders. Tax exempt funds weathered these problems by relying on the credit of the underlying obligor or working with the obligor to substitute another guarantor.[20] The funds did this without any support from their sponsors or experiencing an influx of redemptions. This is another example of how tax exempt funds were not a source of problems during the financial crisis.

The Reform Proposal also cites news articles regarding problems with Dexia late in 2011 and their impact on municipal securities. Federated has obtained from the Federal Reserve information regarding MMF holdings of Dexia in 2011. Our review of this information shows that no MMFs (including tax exempt funds) held securities for which Dexia was an Enhancement Provider during the period covered by these news articles. A review of Form N-MFPs filed

[19] Reform Proposal at 36961.

[20] The Reform Proposal requests comment (at 36966) on whether MMFs should be required to obtain financial data on the underlying issuers whose securities are subject to guarantees. Although Federated obtains underlying financial data when it is a factor in the minimum credit risk determination, it is not necessary or practical to obtain such financial data in every circumstance. For example, if a state guarantees the notes of its school districts, the financial condition of the school districts is not typically relevant to the minimum credit risk determination. In other cases, the financial data may only become relevant (due to a change in the guarantor) after a MMF has acquired the security. Federated does not believe it is possible to craft a rule that would describe every circumstance in which issuer financial data should be obtained, apart from the current general requirement to determine the minimum credit risk of any security, including a security subject to a guarantee.

during the period (which were presumably the original source of the Federal Reserve's information) should confirm this conclusion. Thus, the Reform Proposal fails to substantiate any benefits that would accrue from the elimination of the 25% basket for tax exempt funds.

5. THERE ARE NOT ENOUGH DAILY VRDOS TO ALLOW TAX EXEMPT FUNDS TO COMPLY WITH THE 10% DAILY LIQUID ASSET REQUIREMENT

The Reform Proposal "request[s] comment on whether we should require tax-exempt funds that wish to take advantage of the proposed retail exemption to also meet the 10% daily liquid asset requirements."[21] The request was generated by an analysis of Form N-MFP showing:

> that as of the end of February 2013, 51% of tax-exempt funds maintain daily liquid assets in excess of 10%, and that another 29% maintain daily liquid assets of between 5% and 10% of their portfolios. The average daily liquid assets held across all tax-exempt funds was approximately 9.9% of their total portfolios.[22]

Regarding this analysis, we note that a bare majority of *funds* appeared to hold more than 10% of their total assets in daily liquid assets on February 28. The analysis does not indicate what percentage of tax exempt fund *assets* these funds held. The 9.9% appears to reflect a simple average of funds. We expect that the average would be significantly lower if the Commission's staff weighted it by assets.

In any event, the analysis did not include an assessment of the supply of daily VRDOs (essentially the only form of tax-exempt daily liquid asset[23]) in the market. Thus, the Commission has no reason to suppose that the remaining 49% of tax exempt funds could increase their daily liquid assets above 10% if required to by the Commission. Imposing a 10% daily liquid asset requirement on tax exempt funds would therefore risk eliminating nearly half of the tax exempt funds, and probably a larger percentage of the asset held in tax exempt funds.

The data for Federated's tax exempt funds suggest that the Form N-MFP results may be anomalous. Federated produces a weekly report that includes the amount of daily VRDOs held in each tax exempt fund. An analysis of the reports from January 2011 through June 17, 2013, found that Federated's tax exempt funds held an asset-weighted average of 7.7% of their total assets in daily liquid assets. The average exceeded 10% for only two weeks during the period, while falling below 5% for seven weeks during the period.

The asset-weighted average for Federated's single state funds during the period was even lower: 5.1%. Compliance with a 10% daily liquid assets requirement would be particularly difficult for single state funds, because state tax-exempt daily VRDOs can be hard to find—particu-

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[21] Reform Proposal at 36860.

[22] *Id*. at n. 218.

[23] Investing in Treasury securities or overnight repurchase agreements would result in taxable income to the fund, requiring shareholders to treat part of the fund's dividends as taxable. This would defeat the shareholders' objective of earning tax exempt income and complicate the fund's tax reporting.

larly in smaller states. Due to this lack of supply, Federated has two single state funds that have yet to hold a daily VRDO in 2013.

Thus, the Commission was correct in exempting in the 2010 amendments tax exempt funds from the 10% daily liquid asset requirement based on the lack of an adequate supply of daily VRDOs. Federated doubts that the Form N-MFP data, when more carefully analyzed, shows anything to the contrary. We also believe that further analysis would show that single state funds for smaller states would have particular difficulty in complying with the requirement. Given the much higher percentages of weekly liquid assets normally carried by tax exempt funds, there should not be any serious risk to shareholders from excluding tax exempt funds from this requirement.

6. CONCLUSION

The Reform Proposal does not make a successful case for any significant reform of tax exempt funds. The Commission has acknowledged that tax exempt funds were not a source of the problems encountered during the financial crisis. Although the Reform Proposal cites problems in the municipal market as a justification for elimination of the 25% basket, none of these problems actually had any impact on tax exempt funds. Tax exempt funds weathered the crisis without support from their sponsors or liquidity facilities from the Federal Reserve.

Including tax exempt funds in Alternative 1 would conflict with the Commission's basic mandate. It would harm investors by preventing them from earning tax-exempt returns on their cash. The transfer of cash from tax exempt funds to government MMFs, banks and similar taxable cash investment alternatives would impair capital formation in the municipal market. The resulting loss of funding would reduce competition and raise borrowing costs, thus reducing the efficiency of the municipal market as well.

Alternative 2 would not protect tax exempt funds or their shareholders. It is hard to imagine a tax exempt fund holding less than 15% of its total assets in weekly liquid assets, and still harder to imagine what good a temporary suspension of redemptions or liquidity fee would do for a tax exempt fund that had already experienced the redemptions necessary to reduce its weekly liquid assets to that level.

Finally, tightening the diversification requirements or imposing a 10% daily liquid asset requirement on tax exempt funds would also harm investors. Both proposals are based on unrealistic assumptions about the range of Enhancement Providers and the supply of daily liquid assets available to tax exempt funds. Imposing these requirements would reduce the number of funds available to investors, and increase the credit risk and reduce the yields of the remaining funds, all of which will reduce investor protection, capital formation and the efficiency of the municipal market.

Federated appreciates the opportunity to comment on the Reform Proposal and the Commission's consideration of our comments. Please feel free to contact John McGonigle if you have any questions regarding these comments.

Very truly yours,

/s/ John W. McGonigle
Vice Chairman
Federated Investors, Inc.