

September 16, 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**
**Elimination of the Use of Amortized Cost Method of Valuation by Stable
Value Money Market Funds**

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* (“Release”).¹ This letter will address the proposed rule’s prohibition on the use of the amortized cost method of valuation² by money market mutual funds (“MMFs”)³ that seek to maintain a stable net asset value per share (a “stable NAV”). The proposal would force stable NAV MMFs to value portfolio assets based upon estimated “market-based” valuations from feeds provided by pricing vendors before rounding share prices to the nearest penny. This proposal would apply to any MMF that still would be permitted to seek to maintain a stable share price after adoption of

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

² Rule 2a-7(a)(2) defines the “amortized cost method” of valuation as “the method of calculating an investment company's net asset value whereby portfolio securities are valued at the fund's Acquisition cost as adjusted for amortization of premium or accretion of discount rather than at their value based on current market factors.”

³ Consistent with previous SEC releases, MMFs would be permitted to use amortized cost valuation to the extent other mutual funds are able to do so – where a 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. *Valuation of Debt Instruments by Money Market Funds and Certain Other Open-End Investment Companies*, Investment Company Act Release No. 9786 (May 31, 1977); Release at 36849.

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either Alternative One or Alternative Two.⁴ In other words, the Commission is proposing that the penny rounding method⁵ would be the only method of valuing portfolio assets and determining share prices permitted under Rule 2a-7 for stable NAV MMFs.

The Release provides the following justification for elimination of the amortized cost method:

[W]e are proposing that all money market funds be required to disclose on a daily basis their share price with portfolios valued using market factors and applying basis point rounding. As a result, money market funds—including those exempt from the floating NAV requirement—would have to value their portfolio assets using market factors instead of amortized cost each day. Accordingly, in line with this increased transparency on the valuation of money market funds’ portfolios, and in light of the fact that this increased transparency renders penny rounding alone an equal method of achieving price stability in money market funds, we are proposing that the government exemption permit penny rounding pricing alone and not also amortized cost valuation for all portfolio securities.⁶

The Commission is mistaken in assuming that penny rounding and amortized cost are “equal” methods of achieving price stability in a MMF. While both methods will result in a \$1 price per share, the penny rounding method entails far more delay, costs and operational risk than the amortized cost method.

The Commission held extensive administrative hearings on amortized cost in the early years of MMF operations and rightly concluded that amortized cost is an appropriate means to establish the fair value of MMF portfolios. Since the adoption of Rule 2a-7 decades ago, MMFs

⁴ Under Alternative One, a MMF could continue to seek to maintain a stable share price if it imposed a daily limit on redemptions of \$1 million on each beneficial shareholder (defined under the proposed rule as a “retail” fund) or if eighty percent or more of its total assets are invested in cash, government securities, and/or repurchase agreements that are collateralized fully (defined under the proposed rule as a “government” fund). Under Alternative Two, all MMFs could continue to seek to maintain a stable share price, but redemptions from these funds could become subject to liquidity fees or suspended temporarily under certain conditions.

⁵ Rule 2a-7(a)(20) defines the “penny rounding method” of pricing as “the method of computing an investment company’s price per share for purposes of distribution, redemption and repurchase whereby the current net asset value per share is rounded to the nearest one percent.”

⁶ Release at 36855.

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have been permitted to use either the amortized cost method or the penny rounding method. Yet “today virtually all money market funds use . . . amortized cost valuation . . .”⁷ Amortized cost has been used successfully every business day for four decades by hundreds of MMFs to establish portfolio asset valuations and share prices on many trillions of dollars of transactions.

There are sound reasons for MMFs to continue to use the amortized cost method:

- (1) The amortized cost method of valuing MMF shares reflects the “market-based” share value to the same extent as the penny rounding method. As the Commission’s rules dictate, the amortized cost method can only be used if it fairly reflects the “market-based” net asset value per share. Moreover, the amortized cost method can provide as much transparency to investors as the penny rounding method.
- (2) Prohibiting the amortized cost method for valuing stable NAV MMF portfolios will not produce “mark-to-market” valuations for MMF portfolio instruments. “Market-based” valuations are not more accurate valuations than amortized cost.
- (3) Substituting penny rounding for the amortized cost method will likely push back settlement times by hours, creating end-of-day bottlenecks, or until the next day. It will also introduce operational risks to the settlement process.
- (4) Substituting penny rounding for the amortized cost method will require MMFs to either curtail services for their shareholders or greatly increase the expense and risks of processing redemption orders, or both.
- (5) Prohibiting the amortized cost method for valuing stable NAV MMF portfolios will result in undue reliance by MMFs upon pricing vendors, with technology risks and consequences the Commission has failed to consider.

Each of these points is discussed below.

⁷ *Id.*

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(1) The amortized cost method of valuing MMF shares reflects the “market-based” share value to the same extent as the penny rounding method. As the Commission’s rules dictate, the amortized cost method can only be used if it fairly reflects the “market-based” net asset value per share. Moreover, the amortized cost method can provide as much transparency to investors as the penny rounding method.

As the Commission acknowledges: “either [the amortized cost or penny rounding] method alone effectively provides the same 50 basis points of deviation from a fund’s shadow price before the fund must ‘break the buck’ and re-price its share.”⁸ In the case of a penny rounding fund, more than 50 basis points of deviation forces the MMF to round its share price to the next cent. In the case of an amortized cost MMF, its board must adopt rigorous procedures to obtain valuations for their portfolio assets and to measure deviations between the MMF’s stable NAV and the “current net asset value per share calculated using available market quotations (or an appropriate substitute that reflects current market conditions) [the “shadow NAV”]⁹”¹⁰ If the deviation exceeds 50 basis points, the board must “promptly consider what action, if any, should be initiated.”¹¹ Absent some means of reducing the deviation, such action would include re-pricing the shares at the shadow NAV.¹²

Unlike penny rounding MMFs, a MMF using the amortized cost method may also re-price its shares before the shadow NAV’s deviation reaches 50 basis points. An amortized cost MMF’s board must also act if it believes “the extent of any deviation from the money market fund’s amortized cost price per share may result in material dilution or other unfair results to investors or existing shareholders.”¹³ The board of a penny rounding MMF does not have any

⁸ *Id.*

⁹ The shadow NAV is slightly more “market-based” than a penny rounded NAV, insofar as securities with remaining maturities of 60 days or less are also valued to reflect current market conditions, whereas the penny rounding method values such securities at their amortized cost.

¹⁰ 17 C.F.R. § 270.2a-7(c)(8)(ii)(A).

¹¹ 17 C.F.R. § 270.2a-7(c)(8)(ii)(B).

¹² The methods operate differently when the fund is required to re-price its shares. Once a fund stops using the amortized cost method, it must re-price its shares in the same manner as other mutual funds, rounding the price to the nearest tenth of a cent. A penny rounding fund can continue to penny round even if the deviation is greater than 50 basis points, so (unless the Board determines to stop using the penny rounding method), price changes are reflect in whole cents rather than in tenths of a cent.

¹³ 17 C.F.R. § 270.2a-7(c)(8)(ii)(C).

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equivalent responsibility. In fact, as part of the elimination of the amortized cost method, the Commission has proposed to delete the general requirement that a MMF may “continue to use [the amortized cost or penny rounding] method only so long as the board of directors believes that it fairly reflects the market-based net asset value per share.”¹⁴ This change will weaken the protections to MMF shareholders provided by the board’s oversight of the valuation method.

Under either Alternative One or Alternative Two, the Commission is proposing to require a MMF to post on its website:

A schedule, chart, graph, or other depiction showing the money market fund’s net asset value per share (which the fund must calculate based on current market factors before applying the penny-rounding method), rounded to the fourth decimal place in the case of funds with a \$1.0000 share price¹⁵

An amortized cost MMF can achieve this same degree of transparency by disclosing its shadow NAV rounded to the fourth decimal place. In fact, this is precisely the “market-based” valuation provided in Form N-MFP that the Commission has relied upon to monitor MMFs during the past three years.

(2) Prohibiting the amortized cost method for valuing stable NAV MMF portfolios will not produce “mark-to-market” valuations for MMF portfolio instruments. “Market-based” valuations are not more accurate valuations than amortized cost.

As we have stated in other comment letters,¹⁶ the proposition offered up by advocates of the floating NAV that a floating NAV will provide investors with “mark-to-market” pricing is a

¹⁴ 17 C.F.R. § 270.2a-7(c)(1).

¹⁵ Release at 37004.

¹⁶ Letter from John D. Hawke, Jr. on behalf of Federated Investors to SEC (Sept. 13, 2013) (available in File No. S7-03-13); Letter from John D. Hawke, Jr. on behalf of Federated Investors to FSOC (Jan. 25, 2013) (available in FSOC-2012-0003); Letter from John D. Hawke, Jr. on behalf of Federated Investors to SEC (Nov. 2, 2012) (available in File No. 4-619). 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

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myth.¹⁷ It remains a myth when “marked to market” pricing is used as the basis for a penny rounded share price. The Release states, “the vast majority of money market fund portfolio securities are not valued based on market prices obtained through secondary market trading.”¹⁸ The Release acknowledges that “the secondary markets for most portfolio securities such as commercial paper, repos, and certificates of deposit are not actively traded” and that “most money market fund portfolio securities are valued largely through ‘mark-to-model’ or ‘matrix pricing’ estimates.”¹⁹

Pricing experts have confirmed to us that only a small percentage of money market instruments actually trade daily in the secondary markets. 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 is time-consuming, complicated, and less exact.

Daily “market-based” NAVs are largely based upon “evaluations” and “opinions” of the value of portfolio instruments provided by a pricing vendor, not actual trades.²⁰ Thus, a variation

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floating NAV would largely be accounting or model-based estimates, rather than prices based on secondary market transactions with sizable volumes.”).

¹⁷ 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.”)

¹⁸ Release at 36837.

¹⁹ *Id.* 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. Although there is limited secondary market trading, 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.

²⁰ Footnote 17 of the comment letter filed September 12, 2013 by the Federal Reserve Banks concedes that there are not prices available for many money market instruments because there is not an active trading market in the instruments. Letter from the Federal Reserve Banks to SEC (Sept. 12, 2013) (available in File No. S7-03-13). The footnote goes on to encourage the Commission to continue its efforts to enhance price transparency in the fixed income markets. This encouragement misses the basic point that there is not an active trading market for most of these instruments (because they are so short term and convert to cash at maturity no one needs to trade them), not simply a lack of reporting of trades. Reliance on prices from the primary markets, which is suggested by the

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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.

As described in detail in a separate comment letter, MMFs have elaborate and rigorous procedures to obtain valuations for their portfolio assets and to measure deviations between the MMF’s amortized cost price per share and the “current net asset value per share calculated using available market quotations (or an appropriate substitute that reflects current market conditions)”²¹ As part of this process, and for purposes of “shadow” price comparisons, MMFs currently use independent pricing vendors to obtain “market based” valuations for individual instruments held in the MMF portfolios. These pricing services use models – often “matrix pricing” models – to estimate values of portfolio securities.

In matrix pricing, estimates of the current values of most portfolio assets are derived from the current prices of the small number of money market instruments that actually trade on a given day, as well as the pricing of new issues. The models generate estimated values, taking into account price relationships among types of securities that relate to factors such as the yield curve, remaining maturity and credit risk spreads. Pricing models consider factors similar to those used to calculate amortized cost, such as days to maturity and coupon or discount. Amortized cost, in contrast, is a simple, accurate and fast method of valuing short-term, high-quality, money market instruments that will eventually return their par value at maturity, barring a credit or market event, in which case the instrument cannot be valued using amortized cost.

We have spent considerable time discussing these issues with the portfolio accountant for a number of Federated MMFs and the independent pricing service retained by the portfolio accountant to determine (1) the time it takes the pricing service to value the individual assets in a MMF portfolio (many of which the Commission acknowledges, do not actively trade and, therefore, do not have market prices, and therefore must be individually valued based upon

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Reserve Banks as a proxy, requires price adjustments to reflect different maturities, essentially the same calculation performed when amortized cost is used. Notably, the Federal Reserve Banks use amortized cost to value these and much longer term fixed income assets on their financial statements. *See* Federal Reserve Banks Combined Quarterly Financial Report (Unaudited June 30, 2013) at pages 8, 9, 12, 17.

²¹ 17 C.F.R. § 270.2a-7(c)(8)(ii)(A).

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comparisons to other assets and their location on the relevant curves and other aspects of a pricing matrix) and (2) the time thereafter for the MMF portfolio accountant to review and validate the valuations received and to calculate an NAV for the MMF (based on the valuations of individual assets provided, valuations of newly purchased assets that must be obtained, expenses and income of the fund, number of shares outstanding, and other factors) on a basis other than amortized cost, and (3) the time for senior personnel of the MMF to conduct their own review of the valuations and calculations. At this time, it appears that it will take a minimum of three to four hours to strike a “market-based” price (assuming there are no technology disruptions), based on a given portfolio – a price that varies, if at all, within a narrow range of hundredths of a penny per share.

Portfolio valuations using amortized cost are simpler to generate than model valuations of money market instruments and involve less discretion. We and others have filed extensive commentary on the use of amortized cost valuation by MMFs for their portfolios.²² Use of amortized cost to value short term high quality debt instruments with 60 days or less of remaining maturity is consistent with GAAP valuation principles for any issuer (not just MMFs), and was permitted and used by mutual funds and other public companies long before MMFs were created. Notably, the strongest advocates for the use of amortized cost and other historical cost methods for valuing balance sheet assets have been the members and staff of the Board of Governors of the Federal Reserve System.²³ Recently, when permitting bank short-term investment funds (STIFs) to use amortized cost accounting and round share prices to nearest cent, the Comptroller of the Currency concluded, “[B]ecause . . . investments are limited to shorter-term assets and those assets generally are held to maturity, differences between the amortized cost and mark-to-market value of the assets will be rare, absent atypical market conditions or an impaired asset.”²⁴ Indeed, we are not aware of any movement to require STIFs

²² See, e.g., Letter from John D. Hawke Jr. on behalf of Federated Investors to SEC (Jan. 25, 2013) (available in File No. FSOC-2012-0003); Letter from J. Christopher Donahue to Mary Jo White (May 17, 2013) (available in SEC File for 2012 Special Studies) (transmitting an analysis titled “Assessment of the Impact of Proposed Structural Reforms to Money Market Funds Based on a Review of Their Operations, History, and Regulation”).

²³ See, e.g., Letter from Susan Schmidt Bies, Member of the Board of Governors of the Federal Reserve System, to Robert Herz, Chairman, Financial Accounting Standards Board on Fair Value Measurements Exposure Draft (Oct. 4, 2004) (available in FASB File No. 1201-100). Banks use the amortized cost method to value loan portfolios on their balance sheets. Office of the Chief Accountant, SEC: *Report and Recommendations Pursuant to Section 133 of the Emergency Economic Stabilization Act of 2008: Study on Mark-to-Market Accounting* (Dec. 30, 2008) at 27. As receiver for failed banks, the FDIC uses a similar method, “accreted value,” to determine principal amounts of bank obligations.

²⁴ Short-Term Investment Funds, 77 Fed. Reg. 61230 (Oct. 9, 2012) (to be codified at 12 C.F.R. Part 9).

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to abandon amortized cost valuation and convert to “market-based” pricing, yet STIFs will be an option for some current MMF investors who cannot tolerate a floating NAV.

Amortized cost is also still used to value assets on the balance sheets of banks. With the exception of securities trading portfolios that generally represent a relatively small percentage of bank assets, most bank portfolio assets are loans and other nonmarketable assets for which market price quotes are not readily available. Banks are required to disclose some fair valuation data on their assets, but it is very approximate and does not represent a full mark-to-market accounting of the bank’s assets. The value of a bank’s portfolio is determined primarily using historical cost accounting (subject to adjustments), rather than market valuations. Banks use the amortized cost method to account for loan portfolios on their balance sheets.²⁵ Banks do not calculate or report a mark-to-market “shadow price” for these loans or otherwise seek to gauge the degree to which the amortized cost at which loans are carried on the bank’s balance sheet diverges from market values. Because the loans have durations well in excess of the maturity ranges of MMF portfolios and are lower in credit quality, the divergence between the amortized cost of bank loan portfolios and current market values can be very large.

In contrast, the high credit quality of MMF portfolio instruments, short portfolio duration, and, most important, MMF liquidity requirements, as well as the fact that these instruments are generally held to maturity, means that the amortized cost method for valuing MMF shares is arguably more accurate than “market-based” estimates involving groupings of instruments placed on a curve for purposes of deriving an estimated bid. Under the amortized cost method of valuing an investment company’s portfolio, instruments in the portfolio are valued at the MMF’s acquisition cost as adjusted for amortization of premium or accretion of discount.²⁶ The premise underlying MMF’s use of this method is that high-quality, short-term debt securities and other short term instruments held until maturity eventually will return to their amortized cost value, regardless of any day-to-day disparity between the amortized cost value and market value, and would not be expected to fluctuate much in value. The amortized cost method also is simple, and it allows MMFs to sell and redeem securities throughout the day, in response to investor needs, based upon a known \$1.00 per share value.

²⁵ Office of the Chief Accountant, SEC: *Report and Recommendations Pursuant to Section 133 of the Emergency Economic Stabilization Act of 2008: Study on Mark-to-Market Accounting* (Dec. 30, 2008) at 27.

²⁶ 17 C.F.R. § 270.2a-7(a)(2).

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From an accounting perspective, the mark-to-model process used to obtain “market-based” valuations for MMF portfolio instruments and shares, like amortized cost, is a “level two” fair value estimate of the value of portfolio assets. Neither is an actual current trading market price (a level one valuation). For amortized cost with short-term instruments, the purchase price is a price at which a willing buyer and a willing seller in fact recently transacted in this instrument, and the maturity price is the price at which the issuer will soon redeem and the owner will soon receive payment for the instrument, with the difference between purchase and redemption price accreted daily to the estimated value for the days in between purchase and maturity. With mark-to-model pricing, the observable market inputs are the recent trading prices of different but somewhat analogous instruments, the yield curve and risk spreads from those traded instruments, and adjustments to reflect different maturity dates that are analogous to the daily accretions of interests used in amortized cost valuations. Both amortized cost and model valuations are accorded the same degree of validity for accounting purposes as an estimate of the current fair value of the instrument and as an estimate of the price at which a willing buyer would buy and a willing seller would sell. Both valuation methods are based on the assumption of no “forced sale” of the instrument into an illiquid market. For MMF portfolios, this “no forced sale” valuation assumption is bolstered by maintaining in portfolio a supply of near-term cash that significantly exceeds anticipated near term cash outflows.

MMFs are permitted to use amortized cost *only if* it fairly reflects the market based NAV per share²⁷ and are required to consider what action to take in the event of a material deviation between the two. In other words, the amortized cost method absolutely *cannot be used* if it does not fairly reflect the “market based” NAV per share. The Release acknowledges that “the amortized cost method of valuation and the penny-rounding method of pricing . . . provides a close approximation to market value under normal market conditions”²⁸

Reports based upon public-available information on the shadow prices of MMFs confirm that the model prices closely track the amortized cost value of MMF portfolios. The Investment Company Institute (“ICI”) has produced several studies detailing this point. For example, 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

²⁷ 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.”).

²⁸ Release at 36837.

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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.”²⁹

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. Using publicly available data from Form N-MFP reports showing MMF “shadow” market-based valuations, ICI calculated changes in prime fund share prices on a monthly basis for January 2011 to March 2012. The ICI reported, “ 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.”³⁰

As these data 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.³¹ 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 a 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 theoretical “first-mover advantage” will ever materialize.

The 2012 report prepared by the Division of Risk, Strategy, and Financial Innovation 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

²⁹ Letter from ICI to SEC (Feb. 16, 2012) (available in File No. 4-619).

³⁰ *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).

³¹ *Pricing of U.S. Money Market Funds*, ICI Research Report (Jan. 2011), http://www.ici.org/pdf/ppr_11_mmf_pricing.pdf.

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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 \$0.998.³² 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.

(3) Substituting penny rounding for the amortized cost method will likely push back settlement times by hours, creating end-of-day bottlenecks, or until the next day. It will also introduce operational risks to the settlement process.

According to the Release, "today the principal benefit from money market funds being able to use amortized cost valuation . . . is that it alleviates the burden of the money market fund having to value each portfolio security each day using market factors."³³ This is not entirely accurate. Today, the principal advantage of the amortized cost method is that a MMF does not have to value portfolio securities before calculating a stable NAV for purposes of purchasing, redeeming or exchanging its shares. Using the amortized cost method, a MMF can calculate its NAV within minutes after the time at which the NAV is to be determined, which allows it to quickly process share transactions, pay redemptions and invest sales proceeds. In contrast, using the penny rounding method, a MMF must obtain and verify prices for a fraction of its portfolio, a process that takes several hours, before calculating an NAV that is rounded to \$1.

In plain operational terms, the amortized cost method allows a MMF the ability to process orders in as little time as an hour, while the penny rounding method would, based on our projections, triple the time to perform the same task, assuming a similar process is used to produce "market-based" valuations and NAVs per share as is currently performed for purposes of calculating the shadow NAV. If a MMF prices at the close of the New York Stock Exchange (which is common for MMFs that can be exchanged for fluctuating value mutual funds), the

³² 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>.

³³ Release at 36855.

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MMF would be hard pressed to complete the penny rounding process, wire redemption proceeds and settle fund trades before the close of the Fedwire.

The Commission may not have considered how the elimination of the amortized cost method of valuation and replacing it with penny rounding will push back settlement times by hours or until the next day, creating end-of-day bottlenecks shortly before the Fedwire close even in “exempt” government MMFs, and create conditions of system complexity ripe for a technology breakdown driving widespread settlement fails, all of which will increase risks to investors, intermediaries and markets, for no purpose.

The Release rationalizes that since the Commission also is proposing that all MMFs be required to disclose daily their share price with portfolios valued using market factors and applying basis point rounding, stable NAV funds in any event would have to value their portfolio assets using market factors each day.³⁴ This is the entirety of the Commission’s justification for the proposal – that eliminating the amortized cost method of valuation and permitting only penny rounding will make no difference to stable NAV MMFs. Nothing could be further from the truth. Although it makes no difference to the resulting share valuations, it will be more expensive and operationally difficult to use model pricing at the very least, and quite likely to cause disruption of flows in the entire liquidity markets due to settlement and processing delays.

The Commission could address this by permitting stable NAV MMFs to rely on the prior day’s share price, derived using market-based factors and penny rounding, to transact throughout the subsequent business day, absent action by the board. Alternatively, the Commission could allow use of estimated portfolio asset values that remain unchanged throughout the day generated by pricing services with data inputs to their models from the prior evening or early morning that have grown stale during the day, but using stale estimated prices would not seem to be an appropriate approach. Otherwise, MMFs will need to go through a time-consuming valuation process described above to obtain estimated market values throughout the day for each individual portfolio instrument, even though the penny-rounded NAV of the fund will inevitably be a stable \$1.00 per share. MMFs will not be able to meet shareholder redemption requests throughout the day, as they do now, but will 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. Fund pricing services and fund accountants tell us this will require multiples of current staff and introduce greater risk of errors

³⁴ *Id.*

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and, in the end, meaningless variations – if any – in valuations. While investors may have the convenience of stable value, they will have the inconvenience of delays up to three to four hours in redemptions, to accommodate the valuation process. This would significantly hamper the liquidity of the same-day markets for Treasury and agency securities and repos and have a destabilizing impact at the end of the day prior to Fed wire closing, increasing the risk of fails in the payment systems.

As discussed above, the “market-based” prices that would be used to value portfolio assets under the penny rounding method would be estimated prices provided by a pricing service. The penny rounding method also introduces operational risk to the process of striking an NAV. Systems and communications disruptions may prevent pricing services from transmitting estimated values to the MMF’s pricing agent. Even if the transmission is received, it will need to be reviewed for errors and, if errors are detected, they will need to be resolved before the NAV can be calculated and rounded to \$1. These and other operational failures could easily prevent a MMF from sending redemption wires before the Fedwire cutoff time. Thus, forcing MMFs to switch to the penny rounding method will push back settlement times by hours or until the next day, creating end-of-day bottlenecks shortly before the Fedwire close, and create conditions of system complexity ripe for a technology breakdown driving widespread settlement fails, all of which will increase risks to investors, intermediaries and markets.

The fact that the penny rounding method uses amortized cost to value most of the portfolio makes it especially difficult to comprehend the point of eliminating the amortized cost method. As the Commission is aware, because of the need for MMFs to comply with Rule 2a-7 requirements for 30% weekly liquid assets, 60 days Weighted Average Maturity (WAM) and 120 days Weighted Average Life, approximately 70% or more of prime MMF assets are of less than 60 days duration.³⁵ Since, under the Commission’s proposal, assets of 60 days or less duration will continue to be valued at amortized cost, the proposal creates a situation in which approximately 70% or more of the instruments in a prime institutional MMF – those of 60 days

³⁵ 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). We note that the comment letter filed September 12, 2013 by the Federal Reserve Banks cite similar data from a different source stated that “[a]s of month end June 30, prime MMMFs allocated 55 percent of their portfolios to securities with a final maturity of 60 days or less. Prime institutional MMMFs allocated 56 percent of their portfolios to such securities.” Letter from the Federal Reserve Banks to SEC at n.19 (Sept. 12, 2013) (available in File No. S7-03-13) (citing Crane Data).

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or less in duration – will be priced at amortized cost, while approximately 30% will be priced using matrix-derived estimates, producing an unrounded NAV fluctuation of, perhaps, one or two basis points. Forcing MMFs to switch to penny rounding will therefore impose a three or four-hour delay on trade settlements for the purpose of estimating immaterial fluctuations in market value for a fraction of the portfolio that will not have any affect (due to rounding) on the actual settlement price.

These operational concerns explain why amortized cost and penny rounding are not “equal method[s] of achieving price stability in money market funds.” Even if amortized cost funds must “value their portfolio assets using market factors instead of amortized cost each day,” they may perform this valuation independently of the processing and settlement of share trades. It should not matter when in the evening an amortized cost fund completes the calculation of its shadow NAV, so long as it is completed in time to update the newly required disclosures that must be posted on the fund’s website the next day. A penny rounding fund does not have this flexibility – because the valuation is used to calculate share price rather than monitor any deviation, the valuation process must be completed before orders are processed and settlements occur. This difference makes the penny rounding method an inherently inferior method of achieving price stability, especially if you are a MMF shareholder who needs money before the very end of the day or possibly the next day.

Elimination of the amortized cost method will also throw sand in the gears of daily cash transaction processing. The slower 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 NAV MMFs 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 will create pointless “make work,” 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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(4) Substituting penny rounding for the amortized cost method will require MMFs to either curtail services for their shareholders or greatly increase the expense and risks of processing redemption orders, or both.

The flexibility provided by the amortized cost method allows MMFs to price their shares at multiple times during a day. For example, because market conventions require sale orders for municipal obligations to be placed by 1:00 p.m., Federated's tax exempt funds generally impose a noon cut-off for same-day redemptions. Purchase and redemption orders received by noon are priced and processed as of that time, and redemption proceeds are paid that afternoon. Orders received after noon are typically priced at the close of the New York Stock Exchange (along with any exchange requests) and redemptions are settled the next day.

The cost of calculating multiple stable NAVs using amortized cost is nominal. The fund only needs to factor in certain accounting entries (primarily the accrual of income and expenses, the declaration of the daily dividend) to determine its net asset value, which is then divided by the adjusted number of outstanding shares. Calculating a penny rounded NAV, however, entails substantial costs every time the NAV is calculated. In other words, while a MMF that prices only once a day will incur the same cost to calculate a shadow NAV as to calculate a penny rounded price, forcing a MMFs that prices multiple times during a day to switch to penny rounding will multiply the fund's expenses. Moreover, because the penny rounding method requires several hours, MMFs will not be able to price as frequently as they can using the amortized cost method.

Thus, requiring MMFs to switch to the penny rounding method will necessary result in either a reduction the ability of MMF shareholders to access their cash (by forcing funds to price only once a day, probably at the end of the day) or a substantial increase in MMF expenses (by forcing MMFs to pay pricing vendors for multiple feeds during each day). Pricing services will also increase their charges if asked to provide current estimates at multiple times during the day, as they will have to hire additional personnel and expand their systems capacity. Hence, the expense increase will not be simply a multiple of current expenses, but a multiple of increased expenses. Each iteration of penny rounding will also entail all of the operational risks of failed or erroneous transmissions from pricing services and failed settlements by MMFs.

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(5) Prohibiting the amortized cost method for valuing stable NAV MMF portfolios will place undue reliance upon pricing vendors to MMFs, with technology risks and consequences the Commission has failed to consider.

As discussed in other comments, 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 eliminate the amortized cost method of valuing MMF portfolios will *not* produce mark-to-market NAVs for MMFs. Indeed, pricing vendors are completely candid in describing the valuations they produce. For example, one 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.”³⁶

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.

³⁶ *Evaluation Services*, Interactive Data Corporation (last visited Sept. 16, 2013), <http://www.interactivedata.com/index.php/productsandservices/content/id/Evaluation+Services> (emphasis added).

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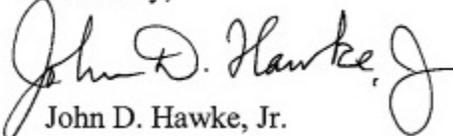
As we have raised in other letters, there are substantial operational and technology risks that would be created as well by wholesale reliance upon pricing services to produce timely valuations for purpose of calculating MMF share valuations for transaction purposes. What would happen, for instance, 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? 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 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.

Conclusion

Federated views the process of obtaining “market-based” valuations as important to assuring that a MMF’s stable NAV fairly reflects the value of its portfolio holdings. Indeed, a MMF board is obligated to take action if it does not. Federated, like many other fund advisers, has gone further than any statutory or regulatory requirement by posting daily shadow NAVs, based on market factors, for five of its prime MMFs. But “market-based” valuations are not necessary for a MMF to calculate a stable NAV.

As the Commission acknowledges, the penny rounding and amortized cost methods are “equal” in terms of their output: both result in a stable \$1 per share value and the shadow NAV calculated under the amortized cost method is equivalent to the NAV before penny rounding. The two methods are also very similar in terms of their inputs: even using the penny rounding method, more than 70% of the portfolio will be valued at amortized cost. But in terms of flexibility, delay, risk and costs, the penny rounding method is decidedly inferior to the amortized cost method. This is why there do not appear to be any MMFs that currently use the penny rounding method to value their shares. The Commission has no basis for prohibiting a method that is universally recognized as the most efficient and effective means of achieving price stability in MMFs.

Sincerely,


John D. Hawke, Jr.