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

Re: Proposed Rule on *Money Market Fund Reform; Amendments to Form PF*; Release No. S7-03-13
<u>Relationship to Local Government Investment Pools ("LGIPs")</u>

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 rules on money market fund ("MMF") reform (the "Release").[1] Federated is submitting several comment letters addressing various issues raised by the Release. This comment letter focuses on the issues raised by the Commission in Sections III(A)(6)(c) and III(E)(1) of the Release regarding the potential effects of the Commission's proposed amendments to MMF rules upon local government investment pools ("LGIPs").[2]

Accounting requirements for state and local governments are established under applicable state and local law, rules and policy as well as standards set by the Government Accounting Standards Board ("GASB"). These state and local requirements and GASB Standards also apply to LGIPs, which are investment pools operated by state governments to hold state and local government assets. Many LGIPs are operated by state governments to invest liquid assets and have features similar to a MMF, including daily liquidity and a stable unit value of $1 per unit. All LGIPs are permitted under GASB Standards to value a very large portion of their portfolio assets at amortized cost. Those LGIPs that choose to conform to the requirements of Rule 2a-7 (referred to by GASB as "2a7-like" LGIPs) are permitted by GASB Standards to value all of

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

2 Release at 36870, 36914-20.

their assets at amortized cost.

Federated has almost 40 years of experience in the business of managing MMFs and, during that period, has participated actively in the money market as it has developed over the years.[3] In addition to serving as investment adviser to MMFs, Federated also serves as investment adviser to several LGIPs that are operated by state governments for investment of cash assets.

State and Local Government Cash Management Needs and the Role of LGIPs.

State and local governments manage large cash positions that are needed in the context of providing governmental services to the public. Cash inflows are generated from taxes and user fees of various sorts and transfer payments from the federal government as well as borrowings. This cash is held and used by state and local governments to pay for expenses such as payroll and benefits for teachers, police, firefighters and emergency personnel, provide services to low and moderate income and elderly individuals, fund the judicial system, operate transit systems, water systems and sewage systems, collect and dispose of refuse, build and maintain schools, roads, rail lines, airports, hospitals, parks and other public facilities and infrastructure, and make payments of interest and principal on borrowings. Much of the basic infrastructure and services that the public relies upon every day is provided by state and local governments. The cash to pay for all of those things is managed by state and municipal treasurers. Some of the cash balances managed by governments are earmarked for particular departments or functions (such as a hospital system or university, or for payments on a bond) and held as a separate cash account. Other cash accounts are held for general purposes and eventually spent as authorized by the governmental entity.

State and local governments are subject to statutory and contractual limits that establish the types of assets in which cash balances are permitted to be invested. Consistent with these requirements as well as operational and prudence considerations, state and local governments use several different methods to hold and manage their cash. A portion is placed in deposit accounts at banks. A portion is invested in shares of MMFs. Federated estimates the amount invested by state and local governments in MMFs at well over $100 billion.[4] A portion is invested directly

[3] The registration statement for Federated's Money Market Management fund first became effective on January 16, 1974, making it perhaps the longest continuously operating MMF to use the amortized cost method of accounting. Federated also received one of the initial exemptive orders permitting use of the amortized cost method of accounting in 1979.

[4] *See, e.g.* Attachment to Letter from Conference of Mayors to Commission (July 18, 2013) (available in File No. S7-03-13) (stating the amount at $119 billion at year-end 2012). As the Commission is aware, state and municipal

Footnote continued on next page

by state and local governments in repurchase agreements, Treasury notes, and other money market instruments.

A portion of state and local government cash balances is in LGIPs. Federated understands that as of January 1, 2011 there were more than 107 LGIPs used in 44 states, with total assets in excess of $225 billion.[5] Forty-six of these LGIPs had assets over $1 billion. The twenty-five largest LGIPs accounted for approximately three-quarters of total LGIP assets. Approximately two-thirds of LGIPs were operated as stable value funds that seek to maintain a NAV of $1 per unit. Roughly two-thirds of LGIPs retain external investment management firms (including Federated) to manage the assets of the LGIP and one third are managed by employees within state and local government agencies.

Potential impact of Rule 2a-7 amendments on LGIP accounting requirements.

The Commission requests comment on the potential impact upon LGIPs of the proposed amendments to rules governing MMFs. The Commission notes that it is "unable to predict how various state legislatures and other market participants will react to our floating NAV proposal" and that it does "not have the information necessary to provide a reasonable estimate of the impact on LGIPs or the potential effects on efficiency, competition, and capital formation."[6] The Commission asks how its floating NAV proposal would affect LGIPs, whether there are costs involved that the Commission has not considered, and how "states . . . would react to our floating NAV proposal?"[7] The Commission posits that "state statutes and policies may need to be amended to permit the operation of investment pools that adhere to rule 2a-7 as we propose to amend it" and that "it is possible that states could amend their statutes or policies to permit the

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governments have consistently indicated the importance of MMFs to their cash management operations and voiced their strong opposition to the imposition of a floating NAV requirement on MMFs. *Id.;* Letter from Government Finance Officers Association, International City/County Management Association, National Association of State Auditors, Comptrollers and Treasurers, National Association of State Treasurers, National League of Cities, National Association of Counties, U.S. Conference of Mayors, American Public Power Association, and Council of Infrastructure Financing Authorities to Commission (Aug. 19, 2013) (available in File No. S7-03-13); Letter from Association of Indiana Counties to Commission (Aug. 13, 2013) (available in File No. S7-03-13); Letter from North Carolina Metropolitan Mayors Coalition to Commission (July 24, 2013) (available in File No. S7-03-13).

5 Source: iMoneyNet Special Report Government Investment Pools: Investment Strategies, Facts, Figures and Trends (Dec. 2011).

6 Release at 36870.

7 *Id.*

operation of LGIPs that comply with rule 2a-7 as we propose to amend it."[8] The Commission then asks whether "commenters believe that states would amend their statutes or policies to permit LGIPs to have a floating NAV per share provided the fund complies with rule 2a-7, as we propose to amend it?"[9]

As discussed below, Federated believes that the Commission misapprehends the relationship between Rule 2a-7 and the ability of LGIPs to continue to maintain a stable NAV, as well as the willingness of state and local governments to adopt a floating NAV requirement for LGIPs.

In view of the facts that: (a) states currently could choose to amend their statutes and policies to operate LGIPs as floating NAV pools, but generally have not done so; (b) the great majority of LGIPs that are intended to hold liquid assets operate with a stable NAV; and (c) state and municipal governments have loudly voiced their opposition to imposing a floating NAV on MMFs; it seems highly unlikely that states would rush to embrace a floating NAV for LGIPs simply because the Commission amends Rule 2a-7 as proposed in Alternative One. Instead, the far more likely result of such an action by the Commission is that LGIP accounting standards would be further de-coupled from an amended Rule 2a-7 through interpretation, clarification or amendment to the accounting guidance, and state and local government balances would shift (under new rules adopted under Alternative One) from floating NAV MMFs to stable value LGIPs.

State and local governments (and GASB) will, however, incur significant costs and administrative burdens in sorting through and resolving the accounting issues involving use of amortized cost accounting by "2a7-like" LGIPs.

LGIPs Are Not Regulated Under Investment Company Act

LGIPs are exempt from registration and regulation under the Investment Company Act pursuant to Section 2(b) of that Act.[10] Amendments to rule 2a-7 will not directly apply to LGIPs.

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[8] *Id.*

[9] *Id.*

[10] As of January 1, 2011, only three LGIPs were voluntarily registered with the Commission under the Investment Company Act. The other 100 plus LGIPs operate within the exemption provided by Section 2(b) of the Investment Company Act for "a State, or any political subdivision of a State, or any agency, authority, or instrumentality of any one or more of the foregoing, or any corporation which is wholly owned directly or indirectly by any one or more of the foregoing.…" Source: iMoneyNet Special Report Government Investment Pools: Investment Strategies, Facts, Figures and Trends (Dec. 2011).

The effect, if any, would be indirect and as a result of incorporation of Rule 2a-7 provisions into a GASB Standard that establishes requirements for an external pool LGIP to qualify as a "2a7-like" pool in order to use amortized cost to value *all* of its portfolio assets. Specifically, a possible effect of the Commission's amendments would be to create a period of uncertainty over which requirements of Rule 2a-7 LGIPs would need to meet to remain "2a7-like" and continue to be permitted to use amortized cost to value all of their assets. As the Commission notes, the indirect effect, if any, depends on future actions of state governments and the GASB.

Use of Amortized Cost by State and Local Governments, Internal Pool LGIPs

Under GASB Standards, state and local governments are permitted to value at amortized cost those short-term debt instruments that have a remaining term of up to one year if owned directly by the governmental entity. LGIPs that are beneficially owned by a single government reporting entity (an "internal pool") are also permitted to use amortized cost to value assets with a year or less of remaining maturity. For LGIPs that are beneficially owned by more than one government reporting entity ("external pools"). GASB Standards permit a "2a7-like" LGIP to value all of its portfolio assets at amortized cost. LGIPs that are not "2a7-like" are required to mark most assets to market (or model) that have a remaining maturity of more than 90 days.

A "2a7-like" pool is an LGIP that chooses voluntarily to follow the main requirements of Rule 2a-7. Not all stable value LGIPs operated by states for management of liquid assets are "2a7-like" pools.

"2a7-like" LGIPs

Many states operate LGIPs as cash management pooled investment funds. These LGIPs typically are managed in a way similar to MMFs and may voluntarily follow some portion of current Rule 2a-7. LGIPs that operate as "2a7-like" external pools are allowed to use amortized cost to value all of their assets.[11] GASB chose to reference the requirements of Rule 2a-7 as a convenient way to adopt a set of standards for appropriate portfolio restrictions and standards that would be consistent with the use of amortized cost. It was not an effort to cede to the Commission authority to establish accounting or portfolio management standards for LGIPs.

This "2a7-like" pool treatment is available to those external pool LGIPs that voluntarily comply with Rule 2a-7 conditions. Some ambiguity exists, however, as to exactly what requirements within Rule 2a-7 a pool must follow to qualify as "2a7-like." The conditions of Rule 2a-7 that are specifically referenced in GASB guidance as supporting this treatment include

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[11] GASB Statement 31 (Mar. 1997); GASB Statement 59 (Jun. 2010).

the liquidity, asset quality, diversification and short portfolio requirements of Rule 2a-7. These conditions help assure the stable value of the portfolio and support the assumptions underlying the use of amortized cost accounting. As noted in GASB Statement 59, "2a7-like" LGIPs do not need to comply with all requirements of Rule 2a-7. For example, LGIPs are not registered under the Investment Company Act or subject to its requirements, and most do not have boards of directors with the duties and obligations required under the Investment Company Act (some having advisory boards or no boards) but have instead executive officers authorized to enter into contracts on behalf of the LGIP.

Possibility for Indirect Impact on "2a7-like" LGIPs' use of Amortized Cost

Amendments to Rule 2a-7 could affect "2a7-like" LGIPs indirectly, depending on future actions of the GASB and states in establishing the operating and accounting standards for LGIPs. It is not yet entirely clear whether amendments to Rule 2a-7 prohibiting the use of amortized cost to value assets with more than 60 days' remaining maturity and requiring that shares be priced to the hundredths of a cent would be applied by GASB or a state to a "2a7-like" LGIP. These requirements relate to how portfolio valuations are conducted and how share prices are calculated, rather than to the definitional characteristics and investment and portfolio requirements of a MMF. It would be illogical to require "2a7-like" LGIPs not to use amortized cost for assets with a remaining term over 60 days, as a condition to using amortized cost under the GASB guidance. Such conditions would seem therefore not to be elements of Rule 2a-7 that "2a7-like" LGIPs must follow.

Movement of MMFs to a floating NAV or the abandonment by the Commission of amortized cost accounting to value MMF shares, could require further work and action by GASB and State and local governments to determine the appropriate treatment for LGIPs. GASB recently scheduled this as a potential project in its technical plan.[12]

The impact also depends in part on the terms of the state's LGIP documents and requirements and whether the state chooses to conform to all amendments to Rule 2a-7.

[12] GASB: Technical Plan for Final Third of 2013 "Potential Projects" at p. 4 (rev. Aug. 9, 2013) (available at http://www.gasb.org/cs/BlobServer?blobkey=id&blobwhere=1175827494871&blobheader=application%2Fpdf&blobcol=urldata&blobtable=MungoBlobs). *See also* GASB Project Page: Fair Value Measurement and Application, (available at http://www.gasb.org/cs/ContentServer?site=GASB&c=GASBContent_C&pagename=GASB%2FGASBContent_C%2FProjectPage&cid=1176156646208); Preliminary Views of the Governmental Accounting Standards Board on major issues related to Fair Value Measurement and Application, Project No. 26-5P (available at http://www.gasb.org/cs/BlobServer?blobkey=id&blobwhere=1175827186112&blobheader=application%2Fpdf&blobcol=urldata&blobtable=MungoBlobs).

Reviewing the changes and their relevance to LGIPs, and determining whether and how to revise local requirements, will be time consuming to state and local governments. Preparing and implementing any changes would impose significant costs and administrative burdens on state and local governments.

Federated anticipates that the likely result of GASB and state accounting work following any adoption of Alternative One, the elimination of amortized cost accounting or the imposition by the Commission of other requirements on MMFs outside the portfolio management requirements prudently applied to a cash portfolio, would be to further separate LGIP requirements from those applicable to MMFs.

Cash Management LGIPs that are not "2a7-like"

If an LGIP does not qualify as "2a7-like" it still may use amortized cost to value a large portion of its money market assets.

"External pool" LGIPs, which are owned by more than one governmental reporting entity (for example, participating government investors include more than one municipality), are subject to somewhat more restricted use of amortized cost accounting to value portfolio assets. All external pool LGIPs, including those that are not "2a7-like" pools, are permitted to use amortized cost to value short-term money market portfolio assets with 90 or fewer remaining days to maturity. All LGIPs are permitted to use amortized cost to value "non-participating" money market instruments (non-marketable debt instruments that do not take market changes into account in redemption features). Amendments to Rule 2a-7 will not affect the ability of non-"2a7-like" LGIPs to use amortized cost to value their assets.

Amortized cost is not needed to maintain a stable net asset value of $1 per unit at an LGIP when prices are rounded to the nearest penny per unit. GASB Standards do not require an LGIP to be a "2a7-like" pool in order to round shares to the nearest penny or to attempt to maintain a price of $1 per unit.

OCC STIF Rule

The Office of the Comptroller of the Currency ("OCC") recently amended its Rule 9.18 governing bank short-term investment funds ("STIFs"). STIFs are collective investment funds used by banks to invest cash balances of state and local governments, trust accounts and pension plans.[13] The OCC's STIF rule was amended to adopt variations on some portions of the

[13] 12 C.F.R. § 9.18(b)(4)(iii); 77 Fed. Reg. 61237 (Oct. 9, 2012).

Commission's Rule 2a-7. The OCC's amended STIF rule continues to allow the use of amortized cost accounting to value portfolio assets, and rounding of unit prices to the nearest penny to allow STIFs to seek to maintain a stable NAV of $1 per unit. The OCC determined that there were good and sufficient reasons to continue to allow STIFs to value their assets using amortized cost accounting and round unit values to the nearest penny. As with bank STIFs, there appears to be no reason that all aspects of the Commission's Rule 2a-7 should be applied to LGIPs.

Why LGIPs Prefer to Use Amortized Cost Accounting

Governments prefer to use amortized cost to value portfolio assets of an LGIP, because money market instruments can be valued more quickly and efficiently with amortized cost than with "mark-to-model" valuation. Amortized cost is a quick and accurate means to value money market instruments of the types held by an LGIP that operates as a cash pool. The difference between the purchase price of the asset and its maturity value is divided by the number of days to maturity, giving a daily amortization factor, which is added to the valuation of the asset each day.

If a pool is not permitted to use amortized cost to value all of its assets, it must instead seek to value its portfolio assets in some other way. Mark-to-model valuation is more expensive than using amortized cost, because an external pricing service must be paid each time new valuations are generated to value the portfolio. "Mark-to-model" valuations of portfolio assets do not improve the quality or accuracy of the valuations of the individual portfolio assets, the pool as a whole, or the pricing of units of the pool. Mark-to-model valuation does, however, complicate and slow down the process for establishing unit values, thereby delaying settlement of fund unit purchases and redemptions.

When valuing some types of money market instruments, true "mark-to-market" pricing is not available. Portfolio assets trade very infrequently. A "matrix pricing" model or a similar model must be used to value portfolios of money market instruments if amortized cost is not used. Like amortized cost, model pricing is an estimate, based on observable inputs, of the value of the asset. Both amortized cost and model pricing are "level 2" valuations, not actual trading prices.

Matrix pricing and similar models derive prices of the whole portfolio in relation to a small number of money market assets that trade, using mathematical price relationships, applying information about credit spreads, current market interest rates, and the yield curve, and include adjustments for remaining days to maturity that are similar to amortized cost factors. There is a lot of math and judgment involved, and a "black box" element to the workings of the models. Two pricing services using different matrix pricing models do not generate exactly the same valuations for the same assets. Model pricing is no more accurate in estimating current market values than is amortized cost accounting. The difference between the “mark-to-model” and amortized cost valuation of a portfolio is very small. In the context of the value of units rounded to the nearest cent it is not material.

Unlike amortized cost pricing, however, model pricing must be re-run with new market data each time that a price is calculated. Model pricing slows down the process for issuing and redeeming shares. And each time the price is generated, new fees must be paid by the LGIP sponsor to the pricing service.

The resulting delays would result in fewer settlements of redemptions, occurring later in the day, and compressed into a short period immediately prior to the close of Fedwire and other payment systems. This can create a queue or backlog in the processing of payments, in some cases delaying settlement to the following morning. This creates unnecessary payment delays and makes it more difficult to coordinate settlement times of LGIP redemptions and purchases with related cash inflows and disbursements of the state or local government that is an investor in the LGIP.

Potential for a Shift of Assets by State and Local Governments from MMFs to LGIPs.

As the Commission notes in the Release, governments may choose to shift cash currently invested in MMFs to other cash management vehicles, including to LGIPs. In the Release, the Commission requests comment on whether investors will redeem shares of MMFs and move their investments to other cash management vehicles if either of the proposed Alternatives is adopted.[14]

State and local governments currently use MMFs as an efficient tool for managing large volumes of short-term liquid assets. MMFs that seek to maintain a stable value per share are permitted investments for many state and local governments, which rely on these funds to obtain ready liquidity, preservation of capital, and diversification of credit. Floating NAV MMFs generally are not permitted investments for state and local governments for cash positions. MMFs that seek to maintain a stable NAV provide a combination of a reasonable rate of return, relative safety and liquidity.

From discussions with state and local government investors, Federated understands that they are concerned that major changes to the regulation and structure of MMFs could make MMFs an impermissible investment for them, or less useful to them as a cash management tool.

[14] Release at section III(E)(1).

The stable share price of MMFs is a critical operational feature that makes them useful to state and local governments as investors of cash balances. Stable value of $1 per share works efficiently with the accounting and payment systems used by treasurers, allowing them to more accurately manage cash balances and make payments with a smaller staff. Movement to a variable NAV would make MMFs far less useful to treasurers, and would require more manual processing than is currently needed with stable NAV products. Comments submitted by state and local governments to Commission and FSOC dockets on MMF issues are very blunt in stating their opposition to imposing a floating NAV requirement on MMFs.[15]

Alternative One Would Cause a Shift of Assets Out of Prime MMFs

If the Commission were to adopt Alternative One, Federated anticipates a significant movement of state and local government cash out of prime MMFs. A daily redemption limit of $1 million per day as contemplated by the "retail exemption" in Alternative One is far too low to accommodate the cash flow needs of any state or of most cities and counties of substantial size.

State and local government investors could use stable-NAV U.S. government securities MMFs, but the very low yields on government MMFs make them a less attractive alternative.

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[15] *See, e.g.* Letter from Conference of Mayors to Commission (July 18, 2013) (available in File No. S7-03-13); Letter from North Carolina Metropolitan Mayors Coalition to Commission (July 24, 2013) (available in File No. S7-03-13); Letter from Association of Indiana Counties to Commission (Aug. 13, 2013) (available in File No. S7-03-13); Letter from Government Finance Officers Association, International City/County Management Association, National Association of State Auditors, Comptrollers and Treasurers, National Association of State Treasurers, National League of Cities, National Association of Counties, U.S. Conference of Mayors, American Public Power Association, and Council of Infrastructure Financing Authorities to Commission (Aug. 19, 2013) (available in File No. S7-03-13); Letter from Commonwealth of Kentucky, Office of Financial Management to Commission (Sept. 6, 2013) (available in File No. S7-03-13); Letter from Massachusetts Municipal Association to Commission (Sept. 9, 2013) (available in File No. S7-03-13); Letter from Government Investment Officers Association to Commission (Sept. 10, 2013) (available in File No. S7-03-13); Joint Letter from Mayors of: Irving, Texas; Fort Worth, Texas; Louisville, Kentucky; Racine, Wisconsin; Cincinnati, Ohio; Raleigh, North Carolina; Salt Lake City, Utah; Arlington, Texas; Mesa, Arizona; Covington, Kentucky; Baltimore, Maryland; Chicago, Illinois to Commission (Sept 12, 2013) (available in File No. S7-03-13). *Accord* Letters from American Public Power Ass'n *et al* (Jan. 10, 2011, Mar. 8, 2012 and Feb. 13, 2013) (available in various Commission comment files); Letter from Hon. Michael B. Hancock, Mayor, City and County of Denver (Jul. 25, 2012) (available in File No. 4-619); Letter from Hon. Stephanie Rawlings-Blake, Mayor, City of Baltimore (Jul. 20, 2012) (available in File No. 4-619); Letter from Utah Ass'n of Counties (Jun. 27, 2012) (available in File No. 4-619); Letter from New York State Ass'n of Counties (Jun. 20, 2012) (available in File No. 4-619); Letter from Hon. James L. McIntyre, Treasurer, State of Washington (Nov. 15, 2011) (available in File No. 4-619); Letter from New Mexico Ass'n of Counties (Jan. 28, 2011) (available in File No. 4-619); Letter from Hon. Ralph Becker, Mayor, Salt Lake City Corporation (Jan. 13, 2011) (available in File No. 4-619); Letter from National Ass'n of State Treasurers (Dec. 10, 2010) (available in File No. 4-619).

State and local treasurers commonly use prime institutional MMFs to hold significant portions of their cash balances, due to their somewhat higher yield and state and local governments' need for additional revenues. A movement of a significant portion of prime MMF balances into U.S. government MMF could further depress yields on the underlying U.S. government securities due to a lack of supply of short-term government obligations to meet the growth in demand, and, if funds become closed to new investors, might reduce their availability to state and local government treasurers.

Alternative Two Would Be a Concern to State and Local Governments, But Cause Less Shift of Balances

In contrast, if the Commission were to adopt Alternative Two, Federated expects that there would be less movement of state and local government assets out of prime MMFs, particularly if treasurers become familiar with the limited conditions and narrow context under which redemption fees or gating might be imposed. Because it would rarely be invoked, while a floating NAV would be in place every day, Alternative Two would be far less disruptive to treasurers' use of MMFs than Alternative One.

The receptivity of state and local governments to Alternative Two would be improved if there were a much shorter limit on the number of days permitted for temporary deferral of redemptions (for example, 10 days), providing MMF boards' with discretionary authority to impose redemption gates and fees to protect investors that is not tied to a specific amount of liquidity, and a clear statement by the Commission that the imposition of redemption fees or gates should rarely be imposed and only in the most extraordinary of circumstances to protect investors.

Where Would State and Local Money Go?

The Commission recognizes in the Release that investors might move their cash investments to:

- MMFs that are exempt from the proposed reforms (retail funds and U.S. government securities funds);
- bank collective trust funds/STIFs;
- LGIPs;
- bank deposits;

- separately managed accounts and direct investments in money market instruments; and

- U.S. private funds & offshore money market funds;

- ultra-short bond funds and short-duration exchange-traded funds ("ETFs").[16]

The Commission asks to which competing cash management products MMF balances would be moved in response to its proposals.

Bulk of Cash Will Likely Shift to LGIPs, US Government MMFs, STIFs

While it is difficult to anticipate exactly where treasurers would shift cash amounts if Alternative One is adopted, based on their stated desire for pooled vehicles with daily transaction capability, reasonable returns and a stable NAV, Federated anticipates that the bulk of the movement will be into LGIPs, U.S. government MMFs, and bank STIFs. These three cash management products most closely match those operational features of prime MMFs.

Some smaller cities and governmental units might be able to qualify to use the "retail" MMF exemption in Alternative One, if they do not have a need to move large balances of cash on a single day. For states and most local governments of significant size, however, the retail exemption will not meet their needs.

U.S. government MMFs are an eligible investment for cash balances of most state and local governments. State and local governments already make significant use of U.S. government securities MMFs. The low returns from U.S. government MMFs, however, will likely cause state and local governments to seek other investments with a modestly more attractive return in order to meet budget needs for a significant part of balances shifted out of prime MMFs.

LGIPs that operate as cash management pools are available in 44 states.[17] Currently, state and local governments have significantly more assets invested in LGIPs than in MMFs. As discussed above, we do not anticipate that adoption of Alternative One would result in LGIPs

[16] Release at 36917.

[17] Source: iMoneyNet Special Report Government Investment Pools: Investment Strategies, Facts, Figures and Trends (Dec. 2011).

being forced to abandon pricing units at a stable NAV. Because these LGIPs provide a set of features similar to prime MMFs (stable NAV, competitive returns, relative safety, liquidity) and are an eligible investment under governing laws and investment policies, we anticipate treasurers who move balances out of prime MMFs in response to Alternative One, would likely shift a significant portion of these balances to LGIPs.

Similarly, some municipal cash balances currently are invested in bank STIFs. As noted above, in its 2012 rule amendments, the OCC chose to retain the use of amortized cost accounting and a stable NAV for STIFs. Because bank STIFs have operational features similar to prime MMFs, we anticipate that some portion of balances removed from prime MMFs in response to Alternative One could shift to bank STIFs.

Some Cash Will Shift to Direct Investments, Bank Deposits

Federated anticipates that some balances will move to bank deposits and direct investments in money market assets if Alternative One is adopted. These other cash investment alternatives are less efficient and have higher costs than investments in stable value MMFs and LGIPs. They are also more difficult to manage, require more time and staffing by a treasurer's cash managers and offer less credit risk diversification and liquidity and involve potentially higher risks and lower net returns than do MMFs and LGIPs.

Some state and local governments might shift some liquid investments out of MMFs and into bank deposits if Alternative One were adopted. Treasurers already use bank deposits to manage a significant portion of their cash balances. Due to the very large size of the accounts, the balances often exceed the $250,000 limit on FDIC deposit insurance. The balance in excess of the FDIC deposit insurance limit generally is required by state or local law to be collateralized by the bank.[18] The National Bank Act and Federal Deposit Insurance Act permit banks to collateralize municipal government deposits over the $250,000 deposit insurance limit.[19] Collateralization increases the administrative difficulty and cost to banks that accept deposits from state and local governments. As a result, bank deposits are not as readily available, pay a lower return, and are less flexible and less liquid than are MMFs.

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[18] *See, e.g.*, Department of State Treasurer, State of North Carolina, Collateralization of Public Deposits (rev. April 2013) (available at https://www.nctreasurer.com/fod/Resources/Collateralization.pdf) (describing North Carolina requirements for collateralization of public deposits at banks); State of Minnesota Office of the State Auditor, Statement of Position, Deposits of Public Funds (Depositories and Collateral) (rev. Sept. 2012) (available at http://www.osa.state.mn.us/other/Statements/DepositsPublicFunds1102Statement.pdf).

[19] 12 U.S.C. §§ 90, 1821(a)(2), 1823(e)(2). OCC Interp. Letter 527 (Sept. 13, 1990).

Some larger-government treasurers may manage a greater proportion of cash through direct investments if Alternative One were adopted. Direct investments in money market instruments, and separate account relationships where the direct investments in money market assets are managed by a third-party investment manager, are available as alternatives for the larger government accounts. These tend to be more costly cash management alternatives to use than MMFs – higher staffing costs in salaries, benefits and overhead to manage a portfolio managed internally (and greater risk of error), and higher transactions cost and management fees if managed externally. In addition, more audit and oversight is required and there is less liquidity and less flexibility in managing the investments, and less portfolio diversification, than when using a MMF. The greater administrative burdens and costs tend to make this a less attractive option for most treasurers.

Drawbacks to Private and Offshore MMFs, Ultra-Short Bond Funds, ETFs

Due to legal restrictions on their permitted investments, Federated does not anticipate that state and local government treasurers are likely to move a significant amount of their cash assets into private MMFs (whether on-shore or offshore) or into variable NAV products such as ultra-short bond funds, ETFs and floating NAV MMFs. Governing investment requirements generally do not contemplate investment of cash balances into private or offshore MMFs that are exempt from SEC registration, or into variable NAV cash management products such as ultra-short bond funds and ETF cash funds. As a result, the variable NAV products and private or offshore funds that operate as MMF-like products do not meet the investment criteria and operational requirements of many treasurers.

Conclusion

In summary, as discussed above, if Alternative One is adopted, GASB and state treasurers will need to assess the degree to which the amended requirements applicable to MMFs must be followed by "external pool" LGIPs that operate as "2a7-like" cash pools and use amortized cost accounting. This review will impose costs and burdens upon state and local governments. We do not believe, however, that the result would be that LGIPs would be conformed to Alternative One and adopt a floating NAV. Instead GASB and the states would be more likely to de-couple external pool accounting guidance regarding use of amortized cost from a floating NAV requirements in Rule 2a-7, and continue to allow LGIPs operated as liquid asset investment pools to maintain a stable net asset of $1 per unit and use amortized cost to value their portfolio money market assets.

Moreover, Federated believes that the Commission's adoption of the Alternative One floating NAV proposal would cause state and local government treasurers to shift their liquidity investments to alternative products, including LGIPs, and thus reduce the amount of MMF assets under management. The Commission's Alternative Two liquidity fees and gates proposal, particularly if modified to limit its term and clarify its intended very limited use, would not cause state and local government treasurers to shift substantial amounts of their MMF investments to LGIPs or other alternative products.

We appreciate the opportunity to offer our comments to the Commission on the potential impact on LGIPs of the proposed amendments.

Sincerely,

John D. Hawke, Jr.

John D. Hawke, Jr.

Cc: Director of Research and Technical Activities
Government Accounting Standards Board