

September 17, 2013

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

**Re: Comment on the Proposed Rulemaking on Money Market Fund Reform,  
Amendments to Form PF: File No. S7-03-13  
Costs of Implementing the Proposals**

Dear Chair White:

We are writing on behalf of our client, Federated Investors, Inc., and its subsidiaries (“Federated”),<sup>1</sup> to provide comments in response to the Securities and Exchange Commission’s (the “Commission’s”) proposal to reform the regulation of money market mutual funds (“MMFs”).<sup>2</sup> Federated is submitting a number of detailed comment letters in order to address the many issues raised by the Release. This comment letter focuses on the costs and burdens that

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<sup>1</sup> Federated has almost 40 years of experience in the business of managing MMFs and has participated actively in the money market as it has developed over the years. Through its MMFs and related services, Federated has served the cash management and investment needs of millions of individual and institutional investors of all sizes, including thousands of intermediaries who, through omnibus accounts, provide Federated-sponsored MMFs to millions of individual and institutional investors. In the financial sector, Federated MMFs are used by securities and commodity exchanges, escrow agents, pension plan administrators, bank trust departments and broker-dealers offering sweep accounts in order to manage the financial affairs of, and to effects transactions for, their clients. Federated MMF investors also include corporations, state and local governments, and other entities who use these funds to manage operating cash balances, handle payroll, and to effect many types of financial transactions. We have previously described the range of MMF investors and the functions MMFs perform for these investors in letters filed with the Commission. See Letter from John D. Hawke, Jr. on behalf of Federated Investors to Commission (Sept. 13, 2013) (available in File No. S7-03-13); Letter from John D. Hawke, Jr. on behalf of Federated to Commission (Nov. 2, 2012) (available in File No. 4-619); Letter from John D. Hawke, Jr. on behalf of Federated to Commission (Feb. 24, 2012) (available in File No. 4-619).

<sup>2</sup> *Money Market Fund Reform; Amendments to Form PF*, 78 Fed. Reg. 36834 (June 19, 2013) (“Release”).

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the Commission's proposed rule changes would place on investors, intermediaries, fund advisers, and the economy as a whole.

The length of the comment period has been insufficient to fully cost out the various proposals and determine their broader economic impact. Some financial institutions we have interviewed have determined not to attempt to assess the costs of implementation of a floating NAV, because such a product will no longer serve their customer needs. We also believe confusion about the scope and intent of the Commission's proposal under Alternative Two (and the need for both further refinement of that proposal and improved communication about its intent) has led to investor concerns that would diminish if these issues are more fully addressed; therefore, any potential macroeconomic impact of investors leaving MMFs with these characteristics would diminish. In addition, we believe the Commission itself may not have fully considered the extent of operational issues raised by the exemptions to the floating NAV, as well as the delays and problems inherent in prohibiting the amortized cost method for stable NAV funds under its proposal. All of this suggests the need for continuing dialog concerning, and refinement of, the proposals, as well as more time to fully cost out the various alternatives.

As described further below, and using our best means of analysis to date, within the time constraints of the comment period, Federated estimates that the initial nationwide costs of implementing a floating NAV would be in the range of at least \$4 billion to \$7 billion. Added to those costs would be an additional \$12 billion to \$15 billion in required capital in the banking system that would result from commercial paper issuers being forced into more costly bank lending. The annual burden on the economy thereafter would be in the range of \$6 billion to \$11 billion every year. The estimated costs of permitting the board of an MMF that experiences decreased liquidity to implement liquidity fees or temporarily to suspend redemptions are dramatically lower. The Release does not demonstrate why the Commission's concerns could not be directly addressed by this far less costly approach. We urge the Commission to carefully consider the following discussion of the costs and burdens that the proposed rule changes would cause.

## **I. The Commission's Obligation to Consider Costs.**

The Commission has proposed to impose either or both of two alternative changes to the regulation of MMFs. Alternative One proposes to implement a floating NAV for a large subset of MMFs, to restrict the use of amortized cost accounting to value MMF assets and MMF share prices for all MMFs, and to provide criteria for exemptions from the floating NAV requirement for stable value MMFs meeting those criteria. The purpose of the proposal is to address the Commission's concerns about the potential for large-scale redemptions from MMFs during a

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period of financial stress or in response to a significant credit event at a MMF.<sup>3</sup> In reference to the financial crisis of 2007-2009, the Release states that “we expect that if a floating NAV had been in place, it could have mitigated some of the heavy redemptions that occurred . . .” at that time.<sup>4</sup> The Release further speculates that a floating NAV *could* alter investor expectations, and that investors therefore *should* become more tolerant of fluctuations in MMF NAVs, and that investors therefore *may be* less likely to redeem in times of stress.<sup>5</sup>

We recently filed a detailed comment letter on behalf of Federated in which we discussed the problems with the floating NAV proposal and, more important, the lack of any data upon which to assume or even speculate that a floating NAV would desensitize investors to MMF fluctuations, make them more aware than they are today of the risk characteristics of MMFs, or make them less willing to redeem from a MMF in a crisis or in circumstances where a MMF experiences a credit event that could lead to a loss in the fund.<sup>6</sup> We do not repeat those arguments here, but note that the Commission’s own Release concedes that even if MMFs employed a floating NAV during the 2007-2008 market disruptions, it “would not have prevented redemptions from money market funds that were driven by certain other investing decisions, such as a desire to own higher quality assets than those that were in the portfolios of prime money market funds, or not to be invested in securities at all . . .”<sup>7</sup> As two Commissioners have noted, “even if there is no stable \$1.00 NAV . . . investors will still have an incentive to flee from risk during a crisis period such as 2008, because investors who redeem sooner rather than later during a period of financial distress will get out at a higher valuation.”<sup>8</sup>

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<sup>3</sup> Release at 36914.

<sup>4</sup> Release at 36850.

<sup>5</sup> *Id.* (emphasis added).

<sup>6</sup> See Letter from John D. Hawke, Jr. on behalf of Federated Investors to Commission (Sept. 13, 2013) (available in File No. S7-03-13). As discussed in that letter, and in letters submitted by numerous academics, investors and market participants, the notion that a floating NAV would prevent or stop runs is not based on hard evidence, and runs counter to the experience of actual floating NAV products. See e.g. Letter from ICI to Commission (Jan. 10, 2011); Letter from Crane Data LLC to Commission (Jan. 10, 2011); Letter from Wells Fargo Funds Management to Commission (Jan. 10, 2011); Letter from T. Rowe Price to Commission (Jan. 10, 2011); Letter from Institutional Money Market Funds Association to Commission (Jan. 10, 2011); Letter from SIFMA to Commission (Jan. 10, 2011); Letter from European Fund and Asset Management Association to Commission (Jan. 10, 2011); Letter from Professors Jill Fisch, University of Pennsylvania Law School, and Eric Roiter, Boston University School of Law, to Commission (Dec. 2, 2011); Professors David Blackwell, Kenneth Troske, and Drew Winters, *Money Market Funds Since the 2010 Regulatory Reforms: More Liquidity, Increased Transparency, and Lower Credit Risk* (Fall 2012) ([http://www.uschamber.com/sites/default/files/reports/FinalpaperwithCover\\_smalltosend.pdf](http://www.uschamber.com/sites/default/files/reports/FinalpaperwithCover_smalltosend.pdf)).

<sup>7</sup> Release at 36850.

<sup>8</sup> Commissioners Daniel Gallagher and Troy Paredes, *Statement on the Regulation of Money Market Funds* (Aug. 28, 2012) (<http://www.sec.gov/news/speech/2012/spch082812dmgtap.htm>).

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The Financial Stability Oversight Council and the Federal Reserve Bank of New York also have conceded that a floating NAV could not prevent runs.<sup>9</sup> Others have observed, and we agree, “what is more likely is that larger than average movements in an overly precise NAV will contribute to increased runs, as more and more investors try to liquidate into [redeem from] a declining fund.”<sup>10</sup>

On the other hand, the Commission’s proposed Alternative Two, which would allow an MMF’s board to impose limited redemption fees and/or temporary suspension of redemptions, is meant to provide tools that would allow an MMF that is facing the threat of heavy redemptions or another event that could result in a material dilution or unfair results to shareholders to stop, slow or otherwise manage heavy redemptions. The Commission also speculates as to the impact of this proposal, positing, that “if money market funds had imposed liquidity fees during the [2007-2009] crisis, it could have resulted in those investors re-assessing their redemption decisions because they would have been required to pay for the costs of their redemptions” and that fees collected might have offset those costs or “been used to repair the NAV.”<sup>11</sup> The Commission further states that a temporary redemption suspension would have allowed a MMF “to stop mounting redemptions and possibly generate additional internal liquidity in the fund while the gate was in place.”<sup>12</sup> Indeed, as the Commission is well aware, the gating of redemptions has, in fact, been demonstrated to stop a run and protect investors – in the case of Putnam’s Institutional Prime Fund, with no dilution and with shareholder value preserved and

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<sup>9</sup> FSOC, *Proposed Recommendations Regarding Money Market Mutual Fund Reform*, 77 Fed. Reg. 69455 (Nov. 19, 2012) (“[W]hile a floating NAV would remove the ability of a shareholder to redeem shares at \$1.00 when the market value is less than \$1.00, it would not remove a shareholder’s incentive to redeem whenever the shareholder believes that the NAV will decline significantly in the future, consistent with the incentive that exists today for other types of mutual funds.”); Patrick M. McCabe, et al., *The Minimum Balance at Risk: A Proposal to Mitigate the Systemic Risks Posed by Money Market Funds*, Federal Reserve Bank of New York Staff Study No. 564 at 6, 54 (July 2012), <http://www.federalreserve.gov/pubs/feds/2012/201247/201247pap.pdf> (“Even if MMFs with floating NAVs remain sizable, they might continue to be vulnerable to runs, since investors in distressed funds still would have strong incentives to redeem.”) See also Letter from Professors Samuel Hanson, David Scharfstein, and Adi Sunderam, Harvard Business School to FSOC (Jan. 8, 2013) (available in File No. FSOC-2012-0003) (“Introducing floating NAVS would not alter incentives for risk taking nor would it reduce incentives to run—investors would still attempt to exit early before illiquid assets have to be sold.”)

<sup>10</sup> Institutional Cash Distributors, LLC, *Operational And Accounting Issues With The Floating NAV And The Impact On Money Market Funds* (Jul. 2013) (available in File No. S7-03-13).

<sup>11</sup> Release at 36878-79.

<sup>12</sup> Release at 36879.

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liquidity quickly restored. Commissioner Gallagher has observed, gating is the “only way to ensure that a run is stopped in its tracks . . . .”<sup>13</sup>

As Federated has commented in a separate letter, we believe the Commission needs to make critical modifications to Alternative Two, in order for the gating and liquidity fee tools to operate effectively and to minimize their potential impact on shareholders. These modifications include giving the board broader authority to use these tools under circumstances necessary to prevent material dilution or unfair results to investors, but narrowing the automatic trigger for their implementation. The Commission acknowledges in the Release, “investors may withdraw more assets under the floating NAV proposal than they would under the liquidity fees and gates alternative because the floating NAV proposal may have a more significant effect on investors’ day-to-day experience with and use of money market funds than the liquidity fees and gates alternative and because many investors place great value on principal stability in a money market fund.”<sup>14</sup> If the Commission carefully crafts Alternative Two and makes it clear in any adopting release that the purpose of the provision is to protect, and not to penalize, shareholders and that it expects boards to impose liquidity fees or suspensions of redemptions rarely and only for so long as necessary to protect the interests of shareholders, we believe there will be far less likelihood of preemptive redemptions, as some commentators have warned,<sup>15</sup> and greater shareholder acceptance of this alternative and a diminished effect of MMF shareholders exiting MMFs. In short, if the Commission chooses Alternative Two over Alternative One, and carefully tailors its provisions, the costs of implementation and broader adverse economic consequences of amendments to its MMF rules will be reduced, and the effectiveness of the proposal in meeting the Commission’s goals will be enhanced.

The Release concedes that there *will definitely* be costs and drawbacks if the Commission adopts either of the proposals as currently drafted. It specifically acknowledges that a floating NAV for MMFs “would come at the cost of removing many of the benefits to investors that are the result of a fund being able to maintain a stable share price.”<sup>16</sup> It also recognizes that Alternative Two would limit the full and unrestricted redeemability of investment company

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<sup>13</sup> Daniel M. Gallagher, *Statement at the SEC Open Meeting on Money Market Fund Reform* (June 5, 2013), <http://www.sec.gov/news/speech/2013/spch060513dmg.htm>.

<sup>14</sup> Release at 36915.

<sup>15</sup> Release at 36881, n. 361 (citing Letter from Professors Samuel Hanson, David Scharfstein, and Adi Sunderam, Harvard Business School to FSOC (Jan. 8, 2013) (available in File No. FSOC–2012–0003)).

<sup>16</sup> Release at 36914.

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shares, which could potentially, in a remote contingency, greatly reduce the utility of MMFs for investors and intermediaries that depend on immediate processing.<sup>17</sup>

MMFs stable share price and immediate redeemability allow MMFs to fulfill a wide range of investment and cash management functions that are inextricably intertwined with the modern financial system. Today, MMFs are used by corporations, state and local governments, insurers, trustees and others in order to seamlessly invest, manage and transfer cash balances. Numerous business practices, as well as accounting and settlement systems, such as bank trust accounting systems, investment sweep systems, and escrow management systems rely on the stable NAV and immediate redeemability. In the past 40 years, MMFs have become so integrated with, and underlie so much of the present financial system, that their presence is taken for granted.

The proposed structural changes to MMFs in Alternative One will affect every one of their users, with downstream effects throughout the country. Alternative One will require thousands of businesses (in every sector of the economy), municipalities, governmental entities, and individuals to change their normal operating practices and pay new expenses. Before adopting these rule changes, and as required by law, the Commission must carefully examine the effects on the economy, including whether its proposals would impede or foster efficiency, encourage or discourage competition, or raise the cost of capital for businesses and other entities that provide jobs and incomes to millions of Americans.

The Administrative Procedure Act (“APA”) and the Federal securities laws require the Commission to apply rigorous economic analysis to its rulemakings and, in particular, to examine the impact of a proposed rule on efficiency, competition, and capital formation.<sup>18</sup> The Investment Company Act mandates that when the Commission “engages in rulemaking and is required to consider or determine whether an action is consistent with the public interest [it] shall ... consider ... whether the action will promote efficiency, competition, and capital formation.”<sup>19</sup> The failure to conduct sufficient economic analysis in its rulemakings has led to reversals of Commission rules by the D.C. Court of Appeals in several recent cases.<sup>20</sup> Moreover, the

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<sup>17</sup> Release at 36879.

<sup>18</sup> National Securities Market Improvement Act of 1996, Pub. L. No. 104-290, § 106. The National Securities Market Improvement Act of 1996 amended the Investment Company Act and other federal securities laws to require the Commission to consider efficiency, competition, and capital formation whenever it is engaged in rulemaking that requires the agency to consider or determine whether an action is necessary or appropriate in the public interest. See Investment Company Act of 1940, § 2, 15 U.S.C. § 80a-2.

<sup>19</sup> 15 U.S.C. § 80a-2(c); *Chamber of Commerce v. Commission*, 412 F.3d 133, 142 (D.C. Cir. 2005).

<sup>20</sup> *Business Roundtable v. Commission*, 647 F. 3d 1144, 1148-49 (D.C. Cir. 2011) (“[T]he Commission has a unique obligation to consider the effect of a new rule upon ‘efficiency, competition, and capital formation,’ . . . and its

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Commission must consider and respond to substantial problems identified by commenters. If it does not, a rule may be stuck down by a court as arbitrary and capricious.<sup>21</sup>

The Commission must also adhere to the guidance for economic analysis set forth in a March 16, 2012 memorandum from the Division of Risk, Strategy and Financial Innovation and the Office of General Counsel (“Guidance”), which is binding on the agency.<sup>22</sup> Prior to her confirmation, the Chair committed to Congress that the Commission would conduct a full economic analysis, including a cost/benefit analysis, in accordance with the Guidance, before implementing any MMF reforms.<sup>23</sup>

The Guidance identifies the “basic elements of a good regulatory economic analysis” for Commission rulemakings. Among those elements is the requirement that the Commission “support predictive judgments and clearly address contrary data or predictions.”<sup>24</sup> In this connection, the Commission’s speculation that a floating NAV *could* alter investor expectations, and that investors therefore *should* become more tolerant of fluctuations in MMF NAVs, and that investors therefore *may be* less likely to redeem in times of stress is wholly unsupported, particularly in the face of contrary evidence that ultra-short bond funds in the U.S. and floating NAV funds in Europe during the crisis experienced heavy redemptions similar to stable NAV

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failure to ‘apprise itself—and hence the public and the Congress—of the economic consequences of a proposed regulation’ makes promulgation of the rule arbitrary and capricious and not in accordance with law. . . . We agree with the petitioners and hold the Commission acted arbitrarily and capriciously for having failed once again — as it did most recently in *American Equity Investment Life Insurance Company v. Commission*, and before that in *Chamber of Commerce [v. Commission]* — adequately to assess the economic effects of a new rule.” (internal citations omitted)).

<sup>21</sup> *Business Roundtable v. Commission*, 647 F. 3d 1144, 1149 (D.C. Cir. 2011) (“[T]he Commission inconsistently and opportunistically framed the costs and benefits of the rule; failed adequately to quantify the certain costs or to explain why those costs could not be quantified; neglected to support its predictive judgments; contradicted itself; and failed to respond to substantial problems raised by commenters.” (emphasis added)).

<sup>22</sup> Division of Risk, Strategy, and Financial Innovation and Office of General Counsel, *Current Guidance on Economic Analysis in Commission Rulemakings* (Mar. 16, 2012) ([http://www.sec.gov/divisions/riskfin/rsfi\\_guidance\\_econ\\_analy\\_secrulemaking.pdf](http://www.sec.gov/divisions/riskfin/rsfi_guidance_econ_analy_secrulemaking.pdf)) (“Guidance”). The Guidance Memorandum is binding on the agency. *Oversight of the Securities and Exchange Commission: Hearing Before the Subcomm. on Capital Markets and Government Sponsored Enterprises of the H. Comm. on Financial Services*, Statement of Commission Chairman Mary Schapiro, 112<sup>th</sup> Cong. (Apr. 25, 2012) (Available: <http://financialservices.house.gov/Calendar/EventSingle.aspx?EventID=290689>).

<sup>23</sup> Responses to Written Questions of Senator Pat Toomey from Mary Jo White, *Nominations of Richard Cordray and Mary Jo White, Hearing Before the Senate Committee on Banking, Housing and Urban Affairs* (Mar. 12, 2013) S. Hrg. 113-3 at 167.

<sup>24</sup> Guidance at 14.

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funds.<sup>25</sup> Moreover, the proposition that investors – institutional investors that are the target of the floating NAV proposal – must be required to transact at a floating NAV to understand what they already know about the fluctuating nature of MMF portfolio values, is simply not credible. Yet the unsupported predictive judgment put forward in the Release – that a floating NAV may sufficiently enlighten MMF investors so that they will refrain from redeeming when they believe the value of their investments will decline – constitutes virtually the entire basis for the Commission’s floating NAV proposal.<sup>26</sup>

Also included in the basic elements of rulemaking under the Guidance is “the identification of alternative regulatory approaches; and ... an evaluation of the benefits and costs—both quantitative and qualitative—of the proposed action and the main alternatives identified by the analysis.”<sup>27</sup> Indeed, consideration of alternatives plays an essential role in a rulemaking. As the *Guidance* explains

[W]hen considering alternatives, it may sometimes make better sense to evaluate the economic implication of alternatives against the proposed rule, since the primary inquiry in considering the alternatives must be whether these alternatives are better or worse (in terms of achieving the regulatory purpose in a cost-effective manner) than the proposed rule.<sup>28</sup>

This accords with Section 4 (*Flexible Approaches*) of Executive Order 13563 of January 18, 2011 (“Improving Regulation and Regulatory Review”)<sup>29</sup> which provides that “[w]here relevant, feasible, and consistent with regulatory objectives, and to the extent permitted by law,

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<sup>25</sup> Letter from John D. Hawke, Jr. on behalf of Federated Investors to Commission at n.11 (Sept. 13, 2013) (available in File No. S7-03-13).

<sup>26</sup> We understand that the Commission may also have put forward the floating NAV proposal in order to prevent jurisdictional intrusion by regulators at the FSOC and Federal Reserve, where there is a lack of experience and background in investment company regulation. We do not believe this is a legitimate basis for a proposal that otherwise does not meet the Commission’s policy goals, and we note the Commission’s preeminent authority in this area.

<sup>27</sup> Guidance at 4. This and other aspects of the economic analysis must be “substantially complete” even at the rule proposal stage. *Id.* at 16 (“The proposing release should include a substantially complete analysis of the most likely economic consequences of the rule proposal . . . [and] should include a discussion of any existing studies or data that bear on the proposal . . .”).

<sup>28</sup> Guidance at 8.

<sup>29</sup> 76 Fed. Reg. 3821 (Jan. 21, 2011). Although the Commission states that it is not obliged to adhere to this and other Executive Orders, it acknowledges that Executive Order 13579 (“Regulation and Independent Regulatory Agencies”), 76 FR 41587 (Jul. 14, 2011), “encourages independent regulatory agencies to follow certain policies set forth in Executive Order 13563” and that its *Guidance* draws upon principles set forth in that Order. *Guidance* at 4.

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each agency shall identify and consider regulatory approaches that reduce burdens and maintain flexibility and freedom of choice for the public.” Thus, consistent with its own policies and those set forth in a series of Executive Orders, the Commission must consider whether alternatives identified are better or worse in terms of cost-effective regulatory choices that preserve flexibility and freedom of choice for investors. The Commission cannot simply measure the tens of billions of dollars of implementation and continuing costs of its floating NAV proposal against the entire costs of a potential future financial crisis. It must measure the costs of alternative approaches to address the specific problem before the Commission – that of reducing or eliminating the potential for the type of heavy redemptions in MMFs that could harm investors and result in destabilizing “fire sales.” Alternative Two, but not Alternative One, is designed to address this potential risk effectively, at lower cost and less disruption to investors and the financial markets. Indeed, the enthusiasm by some for combining Alternatives One and Two is based principally on the fact that Alternative Two would work to “stop a run in its tracks,” while a floating NAV would not.

Finally, under the Regulatory Flexibility Act (“RFA”), the Commission must also conduct a cost-benefit analysis of the effect of its proposal on small entities, unless it would not have a significant economic impact on a substantial number of them.<sup>30</sup> Thus, the Commission must conduct a cost/benefit analysis as to the effects of Alternative One, both with and without a retail exemption, on small business.<sup>31</sup> Similarly, it must perform a cost-benefit analysis under the Small Business Regulatory Enforcement Fairness Act of 1996 (“SBREFA”), unless it demonstrates that the proposed rules will not result in (i) an annual effect on the U.S. economy of \$100 million or more, (ii) a major increase in the costs or prices for consumers or individual industries, or (iii) significant adverse effects on competition, investment, or innovation.<sup>32</sup> Here, the Commission’s release states that the proposal would not have a significant impact on a substantial number of small entities because “there are no money market funds that are small entities.”<sup>33</sup> However, the RFA does not only apply in cases where a regulation directly *applies* to an entity. Rather, the RFA applies when a regulation “directly affects” an entity.<sup>34</sup> Here, many

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<sup>30</sup> See 5 U.S.C. § 601 *et seq.* It is not enough to for an agency to request comment on economic effects. Rather, an agency must affirmatively reach a conclusion on the economic impact and provide sufficient evidence to support it. *Business Roundtable v. Commission*, 647 F.3d 1144 at 1148 (D.C. Cir. 2011).

<sup>31</sup> This would include other forms of a retail exemption, such as one that is based on the use of social security numbers. Such an exemption would be unavailable to small business investors that use Tax Identification Numbers, and place those investors at a competitive disadvantage to small businesses that use Social Security Numbers.

<sup>32</sup> 5 U.S.C. § 801, 804. See also Executive Order 13579 (Jul. 11, 2011); 76 Fed. Reg. 41587 (Jul. 14, 2011).

<sup>33</sup> Release at 36975.

<sup>34</sup> See *Aeronautical Repair Station Ass’n, Inc. v. FAA*, 494 F.3d 161, 177 (D.C. Cir. 2007). There, the FAA promulgated a regulation mandating that air carriers require drug and alcohol testing of employees. The court

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entities of different sizes will be “directly affected and therefore regulated,” even though the proposed rules would not have direct application to them. For example, the proposals would have a significant impact on numerous smaller entities that are investors in money market funds or that do business with money market funds, such as small businesses, transfer agents, distributors, as well as technology designers and suppliers. Many small entities will experience diminished access to credit and payment services provided by MMFs that become subject to these proposed rules. It is not enough to simply conclude that these investors will find other providers. Rather, the Commission must consider how much more these small entities will be charged by other providers.

These requirements of the RFA also obligate the Commission to consider how the proposals’ effects on the commercial paper market will impact small business lending. At present, many financial entities, including large banks that engage in small business lending, are able to obtain inexpensive funding from MMFs that buy their commercial paper. These banks can then lend to small business at competitive rates. If the supply of inexpensive short-term funding were to decrease, these banks will have to pass the costs on to their small business borrowers. The Commission must carefully consider these effects of its proposals.<sup>35</sup>

Under the RFA, “smaller entities” also include small governmental jurisdictions and small non-profit enterprises.<sup>36</sup> If the Commission were to reform MMF regulation in either of the fundamental ways that are being considered, municipal entities and small non-profit organizations that use MMFs would also face higher costs, whether due to the fact that MMFs and intermediaries would pass on the costs of implementation (such as reprogramming of systems, etc.) or because such entities would have to shift their funds from MMFs to more expensive providers. Moreover, MMFs that are subject to the proposed rules are likely to be less

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rejected arguments that an RFA analysis was unnecessary because contractors of air carriers were not “directly regulated” and were not the “targets” of the regulation. Rather, the court held that contractors were “subject to the proposed regulation” for purposes of the RFA even though the regulation was “immediately addressed” to the air carriers, because the regulations applied to employees of the contractors, just as it applied to employees of the air carriers. The contractors were “directly affected and therefore regulated” within the meaning of the RFA.

<sup>35</sup> The Release also fails to consider that new entrants to an industry must start as “small entities,” and does not examine how the proposals would create barriers to entry. The RFA, SBREFA and other directives do not limit the required analysis to existing entities, and it would make no sense for them to do so. It would certainly not be within the intent and spirit of these laws if the Commission failed to consider how its new rules would affect start-up MMFs and MMF sponsors that are attempting to compete with businesses that are already in operation.

<sup>36</sup> 5 U.S.C. § 601(6). In brief, the RFA defines “small governmental jurisdictions” as the governments of cities, counties, towns, townships, villages, school districts, or special districts, with a population of less than fifty thousand. 5 U.S.C. § 601(5). Small non-profit organizations that are independently owned and not “dominant” in their fields are also treated as small entities under the RFA. 5 U.S.C. § 601(4), (6).

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active in the short term debt markets, leading to less liquid and more expensive markets for small municipal and governmental entities that issue short-term debt.<sup>37</sup> The Commission's economic analysis, however, has not included specific consideration of these types of small entities. This is a matter that must be addressed before adoption of any final rules.

## **II. Costs and Burdens of Implementing the Proposals.**

Investors generally use MMFs for two reasons. First, they use MMFs as a lower-risk, diversified investment that provides a competitive rate of return. For this purpose, MMFs are ideal for assets that will only be held for short time periods, or when other markets are not attractive. Second, investors use MMFs to manage liquidity. Their liquidity needs include “(i) transactional cash required for daily liquidity needs (often part of daily ‘sweep’ arrangements); (ii) operational cash that is not part of a daily ‘sweep’ but is need for short-term liquidity (e.g., weekly payroll funding); and (iii) strategic cash that is part of an asset allocation strategy with a longer term perspective.”<sup>38</sup>

Each of the Commission's proposals would have costs, but Alternative One would completely undermine an MMF's ability to perform these functions. Many investors, such as fiduciaries and government asset managers, are simply forbidden from investment in floating NAV vehicles. Many investors have needs that are too large to qualify for a “retail” MMF, and would be unduly hampered by the delays inherent in pricing stable value “government” MMFs (and many institutional investors may have concerns about the ability of government MMFs to absorb a large influx of cash and/or their low yields). For other investors, the costs of the shift to a floating NAV environment would render MMFs no longer useful. While Alternative Two would result in some burdens, with appropriate modifications that are discussed in Federated's comment letter dated September 16, 2013, it would not make MMFs unusable for investors.

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<sup>37</sup> See Letter from James Lewis, President, National Association of State Treasurers to Elizabeth Murphy, Commission (Dec. 21, 2010) (available in File No. 4-619) (expressing concerns that proposed changes to the regulation of MMFs could “reduce or eliminate a market for short-term public and non-profit debt,” “lead to a contraction in short-term public financing” and “increase short-term debt costs for states due to the reduction of placement options.”).

<sup>38</sup> The Northern Trust Company Comment Letter to the Financial Stability Oversight Council at 2 (Jan. 14, 2013).

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***A. Effects of the Proposals on Investors and Intermediaries.***

***1. Assessment and Re-Design of Accounting, Investment and Cash Management Policies, Systems and Software.***

As discussed in our comment letter dated September 13, 2013 on the floating NAV proposal, institutional investors, whether corporations or government entities, have developed rigorous policies and procedures to govern their accounting, investment, and cash management practices.<sup>39</sup> Because they are essential to the institution, these policies and procedures are reviewed and approved at the board level. If the Commission adopts Alternative One, all institutional investors in prime and tax-exempt MMFs will have to re-assess and revise those policies and procedures in order to reflect the new nature of these funds. The revision process will demand input from multiple constituencies within any individual institution, including accounting, treasury, tax, information technology, finance, and legal counsel. Many institutions will also have to retain and pay for external consultants and counsel. The board or equivalent governing authority of the institution will then have to review and approve any necessary changes before they are implemented. Finally, a long-term process of follow-up and review will have to be followed in order to assess whether the revised policies and procedures are effective.

Further, institutional investors (indeed, nearly all investors other than individuals) uniformly use financial software for enterprise management, accounting, cash management, financial reporting, budget planning and other purposes. Many such systems communicate automatically on a daily basis with broker-dealers, banks and fund portals in order to receive share values. At present, the stable \$1.00 NAV is encoded in many of these systems. In addition, nearly every trust department and bank sweep account system in the country is also encoded with the stable \$1.00 NAV.<sup>40</sup> These and other systems that are programmed with the stable NAV as an underlying assumption have multiple advantages in that they are easy to use, less costly to program, and can be used without having to track execution prices. The lack of a share price variable also reduces the risk of errors. Examples of systems that would have to be re-programmed or replaced in order to accommodate a floating NAV include, among others:

- accounting systems for corporate, government and institutional investors;
- systems for managing operating cash balances;

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<sup>39</sup> Letter from John D. Hawke, Jr. on behalf of Federated Investors to SEC (Sept. 13, 2013) (available in File No. S7-03-13).

<sup>40</sup> Letter from American Bankers Association to Commission (Jan. 10, 2011) (available in File No. 4-619). *See also* Letter from American Bankers Association to Commission (Sept. 8, 2009) (available in File No. S7-11-09).

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- enterprise management systems for corporations and institutions;
- payroll processing systems;
- trust accounting systems at bank trust departments;
- municipal bond trustee cash management systems;
- consumer receivable securitization cash processing software;
- escrow processing systems;
- custody and investment manager cash balance management systems;
- 401(k) and 403(b) employee benefit plan processing;
- broker-dealer and futures dealer customer cash balance management programs;
- futures clearinghouse cash balance management systems, and
- cash management account systems at banks and broker-dealers.

As discussed in our March 19, 2012 letter to the Commission, these specialized uses likely account for well over half of total MMF assets.<sup>41</sup>

If institutions are required to purchase, hold and redeem MMF shares at a floating NAV, these accounting and other software systems will have to be re-programmed in order to ensure their continued functionality. Any technologies that derive data from such systems will also have to be reviewed and, in many cases, modified. For example, an institution's accounting software would have to be modified to include new data fields to reflect MMF share values down to four decimal points. Any systems that derive data from the accounting program will then have to be reviewed and revised in order to ensure that they can "read" the new fields without returning an error.<sup>42</sup> For many institutions, these systems are created and customized by software designers and consultants. The change process will require significant, unanticipated payments to these service providers. Other firms and entities with sufficient resources may have created their own systems: for them, the changes will divert personnel from other more

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<sup>41</sup> Letter from John D. Hawke, Jr. on behalf of Federated Investors to Commission (Mar. 19, 2012) (available in File No. 4-619).

<sup>42</sup> Section (8) of our September 13, 2013 letter on the floating NAV proposal provides a more detailed list of the systems upgrades and additional software functions that would be needed to accommodate the floating NAV. Letter from John D. Hawke Jr. on behalf of Federated Investors to SEC (Sept. 13, 2013) (available in File No. S7-03-13).

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productive functions. In any event, after implementation, all of these investors will incur ongoing costs to maintain the new systems.

The costs of revising policies and procedures, technology re-programming, and ongoing maintenance will vary depending on the size of the institution, the scope and complexity of its investment and cash management activities, and the local costs of labor and expertise. The Commission's estimate of costs acknowledges that there are many different automated accounting and financial systems, and that "each money market fund shareholder would also likely be required to perform an in-depth analysis of [the Commission's] floating NAV proposal and its own existing systems, procedures, and controls to estimate the systems modification it would be required to undertake."<sup>43</sup> The Release provides the following range of estimates as to the costs of reviewing and modifying systems for each investor to accommodate the new regulations:

- For an investor with relatively simple modifications: \$123,000-\$253,000.
- For an investor with more extensive modifications: \$1.4 -\$2.9 million.
- Annual maintenance costs for each investor: 5% to 15% of implementation costs.

Even these optimistic estimates should give the Commission pause. First, they are estimated for one single software project, all to be funded and completed within a proposed two year compliance period.<sup>44</sup> Second, there appears to be no allowance for cost overruns, programming errors and the expenses that come with a tight timeframe. Most businesses will be hard pressed to budget the needed cash for such large outlays. Those that cannot will be forced to borrow in order to finance the upgrades. The sudden large expense will be especially hard for state and local governments. Finally, the technology upgrades *would not earn a return or save any money for the user.*

These are high costs for the sake of showing values that are not expected to show much fluctuation. Already we can see that from the investor's point of view, the relatively low returns that prime and tax-exempt MMFs may offer would not justify continued use. Figures 1 and 2, below, illustrate the initial impact of Alternative One on a higher level. The Release does not include an estimate as to the number of investors that would be affected. However, according to a recent study for the U.S. Chamber of Commerce by Treasury Strategies, between 8,000 and

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<sup>43</sup> Release at 36873.

<sup>44</sup> *Id.* at 36974.

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10,000 corporations actively invest in MMFs.<sup>45</sup> Applying the Release's projected cost figures to various numbers within the range of corporate investors estimated by Treasury Strategies produces a projected cost range for corporations to implement Alternative One.

If one assumes that the median number of such investors (9,000) will choose to incur the costs, and multiplies that number by the median amount of the Commission's high and low estimates (\$1.5 million), the rough cost of implementation for corporations would be \$13.5 billion. Even applying the Commission's lowest implementation estimates to just 8,000 corporations would result in implementation costs of \$984 million.

**Figure 1: Alternative One  
Initial Implementation Costs for Corporations**

Corporate Investors Affected	Release estimate: \$123,000	Release estimate: \$253,000	Release estimate: \$1.4 million	Median Release estimate: \$1.5 million	Release estimate: \$2.9 million
4,000	\$492 million	\$1 billion	\$5.6 billion	\$6 billion	\$11.6 billion
6,000	\$738 million	\$1.5 billion	\$8.4 billion	\$9 billion	\$17.4 billion
8,000	\$984 million	\$2 billion	\$11.2 billion	\$12 billion	\$23.2 billion
9,000	\$1.1 billion	\$2.3 billion	\$12.6 billion	\$13.5 billion	\$26.1 billion
10,000	\$1.2 billion	\$2.5 billion	\$14 billion	\$15 billion	\$29 billion

Of course, Figure 1 assumes a distribution where each affected corporate investor incurs the same costs. Figure 2, below, refines the data in Figure 1 by showing total initial implementation costs where the number of affected investors is distributed, albeit in an optimistic fashion. Figure 2 assumes that 35% of the affected investors will incur the Commission's lowest estimated cost of implementation (\$123,000), and that 35% will incur the high-end of the low estimate (\$253,000). Thus, Figure 2 assumes that 70% will incur the lowest estimated costs for implementation.

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<sup>45</sup> Letter from U.S. Chamber of Commerce to SEC at 8 (Aug. 1, 2013) (available in File No. S7-03-13) (submitted a study by Treasury Strategies titled "Operational Implications of a Floating NAV Across Money Market Fund Industry Key Stakeholders") ("TSI Study").

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Figure 2 further assumes that only 20% will incur the lower range of the estimate for complex reprogramming (\$1.4 million), and that only 10% will have to pay the highest estimated reprogramming costs of \$2.9 million. We stress that these are optimistic assumptions – they likely underestimate the initial costs for corporations. And again, these estimates do not include the costs that would be incurred by municipalities, governmental entities, endowments, non-profit organizations and other non-corporate entities.

**Figure 2: Alternative One  
Initial Implementation Costs for Corporations**

Corporate Investors Affected	Implementation Cost Estimate Based on 35% / 35% / 20% / 10% Distribution
4,000	\$2.8 billion
6,000	\$4.2 billion
8,000	\$5.6 billion
9,000	\$6.3 billion
10,000	\$7 billion

Based on the Commission's own estimates, we can see that implementing the Commission's floating NAV proposal would cost American business at least \$2.8 billion and up to \$7 billion. To provide perspective on this amount, \$2.8 billion is the equivalent of 61,148 full time employees at the national annual mean wage.<sup>46</sup> Surely, there are more efficient and productive uses of capital.

The above estimates relate only to initial implementation. The Release estimates that ongoing annual maintenance costs associated with the Commission's floating NAV proposal are expected to be between 5% and 15% of the implementation costs. Figure 3 illustrates the annual costs for corporate investors of maintaining systems to conform with Alternative One by extrapolating data from Figure 2.

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<sup>46</sup> According to the Bureau of Labor Statistics, the national annual mean wage as of May 2012 is \$45,790. Bureau of Labor Statistics, May 2012 National Occupational Employment and Wage Estimates (available at [http://www.bls.gov/oes/current/oes\\_nat.htm#00-0000](http://www.bls.gov/oes/current/oes_nat.htm#00-0000)). \$2.8 billion / \$45,790 = 61,148.

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**Figure 3: Alternative One  
Annual Maintenance Costs for Corporations**

Corporate Investors Affected	Implementation Cost Estimate Based on 35% / 35% / 20% / 10% Distribution	Annual Maintenance Costs (5% - 15% of Implementation)
4,000	\$2.8 billion	\$140 - 420 million
6,000	\$4.2 billion	\$210 - 630 million
8,000	\$5.6 billion	\$280 - 840 million
9,000	\$6.3 billion	\$315 - 945 million
10,000	\$7 billion	\$350 million - \$1.5 billion

The mid-range figure of \$560 million in annual maintenance costs is the equivalent of 12,229 full time employees at the national annual mean wage.<sup>47</sup> Even the lowest estimate here would cross the threshold level to be deemed a “major rule” under SBREFA. SBREFA defines a “major rule” as one that “is likely to result in (A) an annual effect on the economy of \$100,000,000 or more” and authorizes Congressional action to disapprove such a rule.<sup>48</sup> Yet, these estimates only relate to one discrete aspect of Alternative One: the annual costs of maintaining systems that would be borne by corporate investors.

Finally, we note that Treasury Strategies estimated that “total up-front costs for U.S. MMF institutional investors to modify operations in order to comply with a floating NAV will be between \$1.8 and \$2 billion” and that “new imposed annual operating costs will be \$2 to \$2.5 billion (net present value).”<sup>49</sup> These estimates did not include opportunity costs related to lower returns and higher borrowing costs. Treasury Strategies further estimated that the “time required by market participants to fully comply with a floating NAV will be more than two years.”<sup>50</sup>

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<sup>47</sup> \$560 million / \$45,790 = 12,229.

<sup>48</sup> 5 U.S.C. § 802, 804(2).

<sup>49</sup> TSI Study at 3.

<sup>50</sup> *Id.*

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We do not believe Alternative Two would require extensive assessment and re-drawing of accounting, investment and cash management policies, because it would not change the fundamental nature of MMFs: they would retain their stable \$1.00 price per share. Institutional investors may have to verify that they could still use MMFs that are subject to contingent liquidity fees or temporary redemption suspensions under their existing policies and procedures (of course, these investors are already subject to the potential that a MMF board would suspend redemptions and close the fund under existing Rule 22e-3). If not, we believe any necessary changes would be straightforward. Moreover, the extent of necessary software re-programming would be much smaller because liquidity fees or temporary redemption suspensions would only be implicated on rare occasions, and systems that run on an everyday basis would not have to be revised en masse. As a consequence, we believe that if Alternative Two were implemented, institutional investors' costs of assessing and revising policies and procedures would be a small fraction of the costs of Alternative One.

*2. Burdens and Costs Related to Delayed Settlement Resulting from Alternative One.*

Disallowing amortized cost accounting and a stable NAV would also create delays in the settlement of numerous transactions. At present, business users and investment managers can use MMFs to immediately effect payments to settle corporate transactions, fund payroll accounts, and perform myriad other functions on multiple occasions throughout the day. The Commission's proposals would greatly increase the length of time outstanding of the "float," "due to," and "due from" balances tied up in processing transactions.<sup>51</sup> Consequently, it would also increase the default risk associated with transactions between and among counterparties. This insecurity is intolerable for the business user and investment manager. As a result, such investors will have to either (a) calculate an additional settlement risk premium into their transactions, and pass that cost on to others, or (b) abandon MMFs for their purposes and search for other means.

The Release does not attempt to quantify this burden.<sup>52</sup> However, the Commission's *Guidance on Economic Analysis in Commission Rulemakings* makes clear that

[w]here particular benefits or costs cannot be monetized, the release should present any available quantitative information: for example, quantification of the size of the market(s) affected, or the number and size

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<sup>51</sup> Our letters dated September 13, 2013 and September 16, 2013 explain how Alternative One would cause these delays. In brief, even for a stable NAV fund, disallowing use of amortized accounting will create settlement delays due to the time required for the process of obtaining valuations of portfolio instruments and computing market-based NAVs per share.

<sup>52</sup> Release at 36873.

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of market participants subject to the rule. Even without hard data, quantification may be possible by making and explaining certain assumptions.”<sup>53</sup>

The amount of transactions or the number of entities that would be affected by delayed settlement is quantifiable, or at least can be described as the *Guidance* contemplates. In any case, although the Release attempts to minimize the implications of delayed settlement by pointing to two floating NAV funds that it says offer same day settlement,<sup>54</sup> this is not the same as immediate, intra-day settlement, which the stable NAV and amortized cost accounting make possible for today’s MMFs. In any case, the Commission cannot rely on these two funds to conclude that there will be little effect. One of the two funds has not even been opened to investors, so it has no track record to judge.<sup>55</sup> The other floating NAV fund has only about \$54 million in assets.<sup>56</sup> The Commission cannot come to any rational conclusions regarding issues related to an entire industry’s settlement operations based on this single small fund.

### 3. *Burdens and Costs Related to Accounting Resulting From Alternative One.*

Stable-NAV MMFs qualify as “cash equivalents” under current accounting standards.<sup>57</sup> This has several benefits. Because the NAV is fixed at \$1.00 per share, there is no need for investors to recognize gains or losses for accounting purposes. Holding MMFs as a cash equivalent is critical for firms that have debt covenants that require maintenance of certain levels of cash and cash equivalents. Finally, holdings of cash and cash equivalents are indicators of financial strength to counterparties and investors.

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<sup>53</sup> Division of Risk, Strategy, and Financial Innovation and Office of General Counsel, *Current Guidance on Economic Analysis in Commission Rulemakings* (Mar. 16, 2012), at 12 ([http://www.sec.gov/divisions/riskfin/rsfi\\_guidance\\_econ\\_analy\\_secrulemaking.pdf](http://www.sec.gov/divisions/riskfin/rsfi_guidance_econ_analy_secrulemaking.pdf)).

<sup>54</sup> At 36873.

<sup>55</sup> A prospectus for certain variable NAV funds of the Northern Funds was filed in December 2012 (available at <http://www.sec.gov/Archives/edgar/data/916620/000119312512495705/d449473d485apos.htm>). However, no final prospectus is available and we understand that the filing may have been in anticipation of the instant proposals.

<sup>56</sup> See <http://www.bloomberg.com/quote/VNVXX:US>.

<sup>57</sup> Financial Accounting Standards Board Accounting Standards Codification, par. 305-10-20. See also Statement of Cash Flows, Statement on Fin. Accounting Standards No. 95 (Fin. Accounting Standards Bd. 1987) (“[C]ash equivalents are short-term, highly liquid investments that are both: readily convertible to known amounts of cash and so near their maturity that they present insignificant risk of changes in value because of changes in interest rates . . . . Examples of items commonly considered to be cash equivalents are Treasury bills, commercial paper, money market funds, and federal funds sold (for an enterprise with banking operations).”).

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However, it is likely that under present accounting standards, investors would have to classify floating NAV MMF shares as investment securities or available-for-sale securities, which must be held at fair value.<sup>58</sup> This would have several effects. Companies would have to track and reflect any fluctuations in the values of prime and tax-exempt MMF shares on their books, apparently down to four decimal places. Internal audit processes would also have to be implemented in order to review the processing of MMF transactions and the accuracy of records. Moreover, institutional investors' previously apparent liquidity would be intermingled with other investments and become hidden. Finally, provisions of debt covenants would be triggered, with unpredictable consequences for business entities across the country.

The Release states the Commission's qualified expectation that a floating NAV MMF could be treated as a cash equivalent.<sup>59</sup> But many financial officers, executives, directors, and business owners are likely to be less than sanguine about this position, especially in light of the Commission's follow-up statement that they must be on the lookout for events that would cause them to determine their shares are not cash equivalents.<sup>60</sup> Given that MMF shares would be priced to four decimal points, corporate officers may believe they will need to apply more time and resources to monitoring MMF holdings, or to simply re-classify their MMF holdings as trading or available for-sale securities, even if only to avoid *post-hoc* challenges. If they choose the former path, we estimate that a business entity may incur an additional 20 hours per year of such monitoring. Nationwide costs for all corporations would then be in the range of 80,000 to 200,000 hours annually. If the latter, there is no way to estimate, except to note that up to one trillion dollars in liquidity might become hidden within corporate and institutional balance sheets. Still more likely is the probability that corporations and other businesses will decide, in frustration, not to invest in prime and tax-exempt MMFs.

#### *4. Tax Compliance Burdens on Investors Resulting From Alternative One.*

At present, tax compliance for transactions in MMFs is simple: they do not generate gains or losses due to their stable NAV. The stable NAV also means that investors need not track the timing and price of specific share purchases or redemptions.

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<sup>58</sup> See Accounting for Certain Investments in Debt and Equity Securities, Statement on Fin. Accounting Standards No. 115 (Fin. Accounting Standards Bd. 1993).

<sup>59</sup> Release at 36869. We understand that a major public accounting firm has recently filed a comment with the Commission expressing a similar view. Business users of MMFs will need to determine the accounting treatment that their firms will employ for MMF shares, which is in and of itself a burden, and reflects uncertainty.

<sup>60</sup> *Id.* at 36869-70.

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A floating NAV would change this by creating new burdens where once there were none. As the Release notes, investors in floating NAV MMFs would face new paperwork, reporting and administrative burdens related to tax compliance.<sup>61</sup> To be sure, the Commission notes that “any changes in tax burdens likely would be minimal” due to “the relatively small fluctuations in value that we anticipate would occur in floating NAV money market funds.”<sup>62</sup>

But the Internal Revenue Service (“IRS”) requires proof that one neither made nor lost money on a floating NAV fund transaction. Thus, investors in prime or tax-exempt MMFs will have to review and report information about their transactions in their yearly returns. An investor that is classified as an “exempt recipient” under tax regulations will have to track purchases, sales, purchase and sale dates, cost basis, gross proceeds, and whether any gain is long or short-term. They will have to report this data to the IRS. They will also have to keep extensive records in case of audit. Due to the frequency of MMF transactions, the time and effort required to do so will be quite large. Even if an investor is not an “exempt recipient,” the process of completing annual tax returns will become more difficult in a floating NAV environment. Under IRS regulations, these investors will still have to review and retain reports from their MMFs and intermediaries as to the same types of information in order to complete tax returns. Investors will rationally choose to avoid a product that imposes such burdens.

Moreover, as commenters have explained and the Release acknowledges, the stable NAV relieves investors of having to consider the timing of purchases and sales of shares of MMFs, as they must with variable NAV funds in order to ensure compliance with the IRS’s wash sale rule.<sup>63</sup> In a floating NAV MMF, if any redemption resulted in a loss, and occurred within 30 days (whether before or after) of a purchase of shares, the loss will be treated as a “wash sale” and the shareholder will have to adjust the tax basis of the purchased shares. Thus, a meaningless blip in a MMF’s share price would produce an enormous tax and recordkeeping headache for the shareholder. The IRS has proposed guidance in which it has stated that it may not apply the wash sale rules when a transaction results in a loss of not more than 50 basis points, but this merely exchanges one headache for another, because it still requires the shareholder to review and track MMF transactions to ensure compliance with the 50 basis point threshold.<sup>64</sup>

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<sup>61</sup> The related burden on MMFs in creating and sending tax reports is described below.

<sup>62</sup> Release at 36868.

<sup>63</sup> Under this IRS rule, investors may not recognize a loss on the sale of a security if they purchase a replacement security within the next 30 days (or for that matter, if the investor has purchased a replacement security in the 30 days prior to the sale that triggers the loss). Instead, the loss is added to the basis of the replacement security. The holding period for the sold stock is also added to the holding period of the replacement stock. 26 C.F.R. § 1.1091-1.

<sup>64</sup> Proposed Revenue Procedure, *Application of Wash Sale Rules to Money Market Fund Shares*, IRS Notice 2013-48 (July 2, 2013), <http://www.irs.gov/pub/irs-drop/n-13-48.pdf>.

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*5. Burdens and Costs Imposed on Intermediaries.*

To implement Alternative One, intermediaries in MMF transactions, such as broker-dealers, fiduciaries, banks, portals, transfer agents, principal underwriters and administrators will also have to re-tool current systems, or discard their current systems and procure new ones. The types of systems that would have to be changed include sweep systems, systems that receive, accept and process purchase and sale orders, systems that calculate and transmit data for printed confirmations, and systems that report share price data to brokers and investors.<sup>65</sup> In contrast, Alternative Two is not likely to require changes of this kind.

A simple example relates to the Commission's Rule 10b-10,<sup>66</sup> which generally requires broker-dealers to send written confirmation of each and every securities transaction effected for a customer. At present, the rule provides an exception for transactions in MMFs that attempt to maintain a stable net asset value per share, if transaction information is provided on a monthly basis. The Release confirms that this exception would no longer be available if Alternative One is implemented.<sup>67</sup>

Compliance with Rule 10b-10 in a floating NAV environment will entail two types of costs: (1) the ongoing cost of creating and sending trade-by-trade confirmations and (2) the costs of implementing new systems to generate confirmations. For brokers, the additional cost of sending such confirmations would be significant, especially since most customers elect to receive written copies. As to the costs of initial implementation, the electronic systems that broker-dealers employ to effect, track and confirm securities transactions are not currently programmed to create confirmations for MMF trades. Their current systems interface with the systems of MMF and mutual fund providers (whether through portals or otherwise) in ways that would require reprogramming in order bring MMFs within the trade-by-trade confirmation requirements of Rule 10b-10. Where a broker-dealer and fund sponsor are not within the same family of companies, this task will also require time and extensive coordination between personnel.

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<sup>65</sup> Section (8) of our September 13, 2013 letter on the floating NAV proposal provides a more detailed list of the systems upgrades and additional software functions that would be needed to accommodate the floating NAV, including for intermediaries. Letter from John D. Hawke Jr. on behalf of Federated Investors to SEC (Sept. 13, 2013) (available in File No. S7-03-13).

<sup>66</sup> 17 C.F.R. § 240.10b-10(b).

<sup>67</sup> Release at 36934.

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This is but one aspect of the changes that one type of intermediary would have to make in order to implement Alternative One. Other systems that a broker-dealer would have to modify in order to implement Alternative One include systems for sweep programs and online portals. As noted above, other types of intermediaries, such as fiduciaries and banks will also have to modify their systems. The costs of implementing changes across all such systems will vary, due to differences in size and function. However, Treasury Strategies has estimated that fiduciaries will each probably have to expend between \$400,000 and \$425,000,<sup>68</sup> while portals and brokers will each probably have to expend between \$500,000 and \$600,000.<sup>69</sup> Treasury Strategies has further estimated that for large broker-dealers and bank capital markets groups, one-time costs will be between \$3 million and \$3.5 million, with similar estimates for large bank trust departments.<sup>70</sup> These expenses could be passed on to customers in the form of higher management fees, commissions and other costs, making continued use of MMFs still less attractive.

***B. Effects of the Proposals on Funds and Fund Families.***

***1. Lost Management Fees.***

The Commission's proposals, especially Alternative One, would reduce the profitability of sponsoring and managing MMFs. Investment advisers to mutual funds, including MMFs, earn their revenue by charging fees that are based on a percentage of assets under management. As the Commission acknowledges, it is certain that many investors will be compelled, while others will choose, not to invest in MMFs that are subject to the proposals. With less assets under management, fund advisers will earn less.

MMF advisers might be able to recoup some of these lost earnings if they manage government MMFs that are permitted to retain a stable NAV, investors elect to shift their assets to those MMFs, and gross yields in the government securities markets rise above current rates. But investors are not likely to do so, except in small amounts, because of the lower returns earned by government MMFs. Moreover, government MMFs do not have the capacity to absorb such large amounts of investment. In fact, current yields on government MMFs would not be able to sustain any increases to advisory fees – in the present interest rate environment, advisers are already waiving fees in order to produce positive or zero yields. Finally, the expenses of implementing Alternative One (described below) would reduce any such recoupment.

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<sup>68</sup> TSI Study at 29.

<sup>69</sup> *Id.* at 37.

<sup>70</sup> Letter from Treasury Strategies to Commission at 12, 19 (September 12, 2013) (available in File No. S7-03-13) (enclosing a paper titled "Floating NAV Challenges for Broker-Dealer and Trust Business").

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The median and average expense ratios charged by MMF advisers are presently 17 and 18 basis points (0.17% to 0.18%), respectively.<sup>71</sup> Applying these rates to a range of amounts that depart from MMFs illustrates the losses that advisers will incur. If just one-third of assets (approximately \$330 billion) departs from institutional prime funds that are subjected to a floating NAV, then MMF advisers nationwide will lose approximately \$578 million in fees every year.<sup>72</sup> If two-thirds of such assets shift from floating NAV funds, the lost fees for MMF advisers would come to approximately \$1.156 billion. If 75% of assets (\$750 billion) shift from floating NAV funds, the lost fees for MMF advisers would come to approximately \$1.3 billion.<sup>73</sup>

Federated's own belief is that if Alternative One is implemented, even with a "retail" exemption, at least \$660 to \$750 billion would be driven from institutional prime MMFs and at least \$54 billion from institutional investments in tax-exempt MMFs. In ten years, lost fees to investment advisers of institutional prime funds could be in the range of \$11.5 billion to \$13.1 billion. Indeed, if Alternative One is adopted, the result may well be the complete elimination of institutional prime and institutional tax exempt MMFs. Figure 4 illustrates these figures for institutional prime funds in table form.

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<sup>71</sup> Investment Company Institute, *2013 Investment Company Fact Book* at 80. These are historically low rates, due to the current near-zero interest rate environment. Thus, these estimates of lost revenue do not reflect the lost revenues that would result if interest rates in the future.

<sup>72</sup> According to data from the Investment Company Institute, the total of assets under management in tax-exempt and taxable non-government funds that is attributable to investors that identify as "institutional" is approximately \$987,410,000,000. One third of this sum (approximately \$330 billion) multiplied by 0.175% comes to approximately \$577.5 million. See Investment Company Institute, *Money Market Mutual Fund Assets as of August 15, 2013* ([http://www.ici.org/research/stats/mm/mmm\\_08\\_15\\_13](http://www.ici.org/research/stats/mm/mmm_08_15_13)).

<sup>73</sup> Nor would advisers recover such lost revenue by managing separate accounts or private liquidity funds. For the reasons stated in Section III. A., these products are not viable alternatives to MMFs.

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**Figure 4: Alternative One  
Annual Lost Investment Advisory Fees**

Amount of Assets Removed From Institutional Prime MMFs	Investment Advisory Fees Lost (Based on 0.175% Fee)	Approximate Advisory Fees Lost (Ten Years)
\$330 billion	\$578 million	\$5.78 billion
\$540 billion	\$945 million	\$9.45 billion
\$660 billion	\$1.156 billion	\$11.56 billion
\$750 billion	\$1.313 billion	\$13.13 billion
\$1 trillion	\$1.75 billion	\$11.75 billion

Advisory fees lost by advisers of institutional tax-exempt funds would add about \$94.5 million annually to these losses.

The Release does not appear to consider this significant aspect of the costs associated with the proposals. This is a considerable oversight, given the direct impact of the proposal and the size of the potential losses to the mutual fund industry. The Commission's legal obligations under the APA, RFA, SBREFA and related precedent do not permit this failure to thoroughly evaluate the effects of such lost revenues on mutual fund sponsors.

*2. Increased Data, Service and Technology Costs for MMFs and MMF Providers.*

In addition to cutting revenues for MMF sponsors, Alternative One would raise their costs. A floating NAV would require extensive changes to the technology systems, procedures and controls of a fund complex on an enterprise-wide basis, including at the investment advisers, transfer agents, portal operators, sweeps providers, principal underwriters and broker-dealers that support an MMF. Federated has conducted its own evaluation of its programs, technical systems, relations with service providers and operations in general in order to assess the costs of implementing Alternative One. These efforts have included outreach to Federated's independent service providers and intermediaries, including transfer agents, custodians and portal operators. Based on Federated's review, we believe that, at a minimum, implementation of Alternative One, with the exemption for retail investments and government funds as proposed, would cost Federated over \$11 million. We further estimate that Federated's ongoing costs would approximate, at a minimum, \$9.5 million per year.

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Other commenters have arrived at similar conclusions. In its study for the Chamber of Commerce, Treasury Strategies estimated that for a larger MMF adviser, “[a] large team consisting of fund portfolio management, accounting, transfer agent, IT, third-party vendors, system specialists, and clients could accomplish compliance in 18 to 24 months at an estimated cost of \$10 to \$15 million.”<sup>74</sup> Treasury Strategies estimated that ongoing costs related to necessary staff expansion would be an additional \$10 to \$12.5 million per year.<sup>75</sup>

These extraordinary implementation costs are due to the sweeping structural and technology-intensive changes that would have to be made to MMFs and the systems that are used by fund sponsors, advisers, transfer agents, data suppliers, recordkeepers, and others, all of which would have to be planned, budgeted, implemented and finalized within two years. To illustrate, as a preliminary step, Federated would have to create new funds and fund classes in order to implement retail vs. institutional fund structures. This would cost approximately \$1.7 million. In order to effect client outreach, effect shareholder votes, print new regulatory documents, create new sales literature and engage with investors as to the new nature of their shares and alternatives, we estimate that Federated will expend another \$4 million. Revisiting and revising contractual relationships with broker-dealers and other intermediaries to provide for enforcement of the \$1 million redemption limit would cost a further \$1.3 million. Charges from independent pricing services, custodians, recordkeepers, and transfer agents are expected at nearly \$3 million. Upgrades to Federated’s internal systems and systems that interface with customers and transfer agents would cost another \$1.2 million.<sup>76</sup>

Contrary to the Commission’s expectation that ongoing costs will be a low percentage of the costs of implementation, Federated estimates that annual costs to fund sponsors will actually be close to the costs of the initial implementation. Much of the ongoing cost will result from the elimination of amortized cost accounting and the much more frequent price calculations resulting from Alternative One. The Commission’s proposal would effectively require MMFs to consult their securities pricing services multiple times per day, rather than just once per day, as is current practice.<sup>77</sup> This requirement to repeatedly check whether a software model has revised its

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<sup>74</sup> TSI Study at 41.

<sup>75</sup> *Id.*

<sup>76</sup> The proposed exemptions for government or retail MMFs would actually raise, and not reduce, the costs of implementation due to the complexities of the task. Specifically, as discussed further below, creating the systems to implement and monitor the \$1 million redemption limit increases initial and annual costs by about \$3 million and \$2.7 million, respectively.

<sup>77</sup> Release at 36873. At present, and consistent with Commission rules [17 C.F.R. § 270.2a-7(c)(8)(ii)(A)], MMFs and their advisers employ rigorous procedures to value portfolio assets and measure deviations between the MMF’s amortized cost price per share and the shadow price. For these purposes, an MMF’s internal analysts closely review market prices, refer to matrix pricing models and monitor any deviations from the valuations obtained using

Footnote continued on next page

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estimated valuations for instruments that rarely trade or fluctuate in value would increase burdens and costs for pricing services, recordkeepers and MMF sponsors. Based on consultations with its independent providers, Federated estimates that, for the 42 MMFs that it manages, it will have to pay a total of \$5.7 million per year in increased fees charged by pricing services and recordkeepers, and an additional \$1.5 million per year in fees for transfer agent services. Federated also estimates that additional fees will need to be waived on newly created 'retail' MMFs while still other fees will be lost due to funds losing assets. There will also be expenditures to maintain technology, train staff, and oversee omnibus accounts and to monitor daily shadow prices for 42 MMFs. Federated estimates these costs would amount to \$2.5 million. No matter whether these amounts are considered large or small, they do not produce any benefits for a MMF, its shareholders, or to the market. Without such benefits, the Commission cannot possibly justify the increase in expenses under its cost/benefit standards.

We note that the Commission's estimates as to the costs of implementing a retail exemption are highly optimistic, and at the same time, staggering. As the Commission notes, any MMF "relying on the proposed retail exemption would need to be structured to accept only retail investors as determined by the daily redemption limit, and thus any money market fund that currently has both retail and institutional shareholders would need to be reorganized into separate retail and institutional money market funds."<sup>78</sup> The daily redemption limit is proposed to be set at \$1 million, a very low threshold which will necessitate the reorganization of almost all prime funds and tax-exempt funds.

The Release then estimates that the initial implementation costs of the retail exemption "would range from \$1,000,000 to \$1,500,000 for each fund."<sup>79</sup> Ongoing costs are estimated at "20%–30% of the onetime costs, or between \$200,000 and \$450,000 per year."<sup>80</sup> Even assuming that these estimates are borne out, they would be a significant drag on a fund sponsor's revenue: after ten years, the total expense would have come to between \$3 million and \$6.0 million. In an industry with 82 fund sponsors and an estimated 483 funds, total implementation costs of this

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Footnote continued from previous page  
amortized cost accounting. At the same time, MMFs retain independent pricing services to ensure that valuations for each instrument held in portfolio appropriately reflect market conditions.

<sup>78</sup> Release at 36865.

<sup>79</sup> *Id.*

<sup>80</sup> *Id.* at 36866.

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single aspect of the Alternative One would approximate \$480 to \$720 million while annual costs would approximate \$96 to \$216 million.<sup>81</sup>

In contrast, in order to comply with Alternative Two, we estimate that the changes that Federated would have to implement would cost in the range of \$400,000 to \$500,000, and that maintaining the capacity to implement liquidity fees or to temporarily suspend redemptions would be much smaller -- probably around \$164,000. The lower cost here reflects the ability of the affected entity to custom-design its own approach to implementation, as well as the fact that the necessary changes would not be for use in day-to-day operations, but only for rare occasions.

*3. Increased Costs of Other Changes Independent of Alternatives One or Two.*

Independent of Alternatives One or Two, the Commission has proposed to adopt further disclosure and reporting requirements for MMFs. Federated has provided comments as to the advantages and disadvantages of such new requirements by separate letter. In brief, Federated believes that the proposed new disclosures and reports should be carefully tailored to provide information that investors will actually use and that will not disrupt MMF operations or be difficult or impossible to gather. The Commission must carefully weigh the additional marginal benefit to investors if these changes are required without further tailoring. In this regard, we note that disclosing such matters as the purchase date of a security at the lot level, or the yield at purchase of a security that has been sold really has little use for the short-term investors that use MMFs, especially when reported subject to a delay. On the other hand, the time, effort and programming involved with such disclosures would be large, and the Commission notes that the benefit would be "incidental."<sup>82</sup> In brief, the Commission should carefully weigh the relative benefits that could realistically be gained from the disclosures proposed in the Release against the costs of their implementation, and contrast these costs and benefits against the more tailored disclosure and reporting requirements suggested in Federated's comment letter on the subject. In our view, the more tailored disclosure and reporting requirements Federated has suggested would provide substantially all of the benefits at a fraction of the cost and burden of the proposal contained in the Release.

**III. Effects on Economic Growth, Capital Formation, Competition, and Efficiency.**

The effects of the Commission's proposals on the national economy will depend on the amounts of investor assets that would be shifted from affected MMFs. This is a critical matter, and must be approached with the best possible estimates. Based on the record that has been

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<sup>81</sup> In any case, as discussed in other comment letters, transactions of this size are routine account activity for MMFs. It does not make sense to automatically treat such transactions as if they would trigger a market panic.

<sup>82</sup> Release at 36942.

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established over the past three years, it is clear that if the Commission adopts Alternative One, prime and tax-exempt MMFs would lose a substantial portion of assets that they presently hold, with potentially significant negative effects on the economy. On the other hand, if the Commission were to implement Alternative Two, MMFs would remain a viable alternative for investors and would be able to continue fulfilling their useful functions.

If the Commission adopts Alternative One, many investors will shift their assets from prime and tax-exempt MMFs because they are subject to legal, administrative or policy restrictions that forbid them from investing in assets other than stable NAV instruments. Still others will do so because floating NAV MMFs would not meet their needs, or would be too expensive. According to the Release, the Commission

do[es] not have a basis for estimating the number of institutions that might reallocate assets, the amount of assets that might shift, or the likely alternatives under either of our proposals, because we do not know how many of these investors face statutory or other requirements that mandate investment in a stable value product or a product that will not restrict redemptions or how these investors would weigh the tradeoffs involved in switching their investment to various alternative products.<sup>83</sup>

But over the past three years, hundreds of commenters have identified themselves to the Commission as investors that would be prohibited from using floating NAV MMFs, or as investors that would cease or reduce their use of MMFs if a floating NAV were imposed. The Commission has not conducted any systematic surveys or investigations in this regard. It could at least have surveyed the government and corporate entities that filed comments in the past to gauge whether Alternative One and its potential exemptions would suit their needs. The Commission could also review state and federal legal and administrative codes, as well as municipal ordinances, in order to gain some insight into governmental restrictions on investments in such products. In the past, the Commission has engaged consultants to conduct in depth investigations, and convened focus groups of investors in order to assess their reactions to the proposals.<sup>84</sup> Given the need for accuracy of estimates in this matter, we are surprised that the Commission's discussion of the macroeconomic effects of the proposals does not describe any such actions.

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<sup>83</sup> Release at 36916.

<sup>84</sup> See e.g., Siegel & Gale, *Investor Research Report Submitted to the SEC* (July 26, 2012) (<http://www.sec.gov/news/studies/2012/917-financial-literacy-study-part3.pdf>); Abt SRBI Inc., *Final Report: Focus Groups on a Summary Mutual Fund Prospectus* (May 2008) (<http://www.sec.gov/comments/s7-28-07/s72807-142.pdf>).

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In any case, the Commission has received hundreds of comment letters confirming that investors will not use MMFs with a floating NAV. The Commission first solicited comments on a floating NAV for MMFs in 2009, and received an overwhelmingly negative response from MMF shareholders.<sup>85</sup> The Commission also solicited comments in response to the President's Working Group Report on Money Market Mutual Fund Reform in 2010.<sup>86</sup> The FSOC received the same response when it advanced a floating NAV proposal in November 2012.<sup>87</sup>

In 2012, Treasury Strategies reported that 33% of corporate, government, and other institutional users surveyed currently are subject to investment policies, laws, or other restrictions that would prohibit them from investing in floating NAV products.<sup>88</sup> Treasury Strategies also found that forcing MMFs to adopt floating NAVs would drive a large portion of current users out of the MMF market. Of the more than 200 corporate, government, and other institutional users of MMFs surveyed, 79% said they would decrease or stop using MMFs if the fund had a floating NAV. Of that number, 44% said they would stop using MMFs entirely, and a full 72% said they would decrease use by more than half.<sup>89</sup> Treasury Strategies estimated that 61% of the MMF assets currently held by corporate, government and institutional investors would flow out of MMFs if the funds were required to adopt a floating NAV.<sup>90</sup> Fidelity Investments, the largest MMF manager in the United States, has also surveyed its institutional MMF investors. Of institutional investors surveyed, 89% stated a preference to keep the stable NAV, and 57% said they would decrease or discontinue use of MMFs if they adopted a floating NAV.<sup>91</sup> More recently, in a survey of finance and treasury executives by the Association for Financial Professionals, nearly two-thirds of respondents indicated that they would be less willing to invest in MMFs or would eliminate or reduce their current MMF holdings if a floating NAV were required.<sup>92</sup> A Blackrock survey of primarily institutional investors recently submitted to the Commission's comment file confirms that approximately 48% of users surveyed would no longer use prime institutional MMFs if the Commission's floating NAV proposal were

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<sup>85</sup> *Money Market Fund Reform*, 74 Fed. Reg. 32688 (Jul. 8, 2009). Comments are available at <http://www.sec.gov/comments/s7-11-09/s71109.shtml>.

<sup>86</sup> President's Working Group Report on Money Market Fund Reform, 75 Fed. Reg. 68636 (Nov. 8, 2010). Comments are available at <http://www.sec.gov/comments/4-619/4-619.shtml>.

<sup>87</sup> Comments are available at [regulations.gov](http://www.regulations.gov); Docket FSOC-2012-0003.

<sup>88</sup> Treasury Strategies, *Money Market Fund Regulations: The Voice of the Treasurer* (Apr. 19, 2012) ([http://www.ici.org/pdf/rpt\\_12\\_tsi\\_voice\\_treasurer.pdf](http://www.ici.org/pdf/rpt_12_tsi_voice_treasurer.pdf)).

<sup>89</sup> *Id.* at 12.

<sup>90</sup> *Id.* at 11.

<sup>91</sup> Letter from Fidelity Investments to Commission (Feb. 3, 2012).

<sup>92</sup> Association of Financial Professionals, *2013 AFP Liquidity Survey*, at 24.

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adopted.<sup>93</sup> Even more respondents (57%) stated that they could not use an MMF product that did not qualify as a cash equivalent for accounting purposes.<sup>94</sup>

While these surveys do not consider directly the impact of the exceptions for government and retail MMFs, they illustrate the disruptions that would occur in the prime and tax-exempt MMF industries. In our experience, customers demand greater flexibility than would be permitted by the \$1 million exception for retail funds. Holding the effects of investment preference aside, if 33% of corporate, government, and other institutional users are subject to investment policies, laws, or restrictions that prohibit investment in floating NAV products, and they require, as many do, flexible access to liquidity, then surely there will be significant effects on the amount of investments in MMFs. Thus, based on these surveys, communications with investors and our experience, we believe that if Alternative One is implemented, even with a “retail” exemption, at minimum, \$660 to \$750 billion would be driven from institutional prime funds and \$54 billion from institutional tax-exempt funds.

***A. Reduced Earnings On Short-Term Cash Investments.***

MMFs compete with banks and other investment products by offering a market rate of return. Historically, MMFs have offered better returns than competitors, while at the same time offering diversification, ease of use and stability. There are no short-term investment products that perform so well. Simply put, the risk/return profiles of all of the alternative investment vehicles identified by the Commission in the Release are inferior to MMFs. Any investors that cease to use, or reduce use of, MMFs will forego receiving returns that support growth, foster economic development and contribute to hiring.

For the reasons described in Section II, investors will not merely shift substantial portions of their assets to government funds, especially due to their low returns. The Release identifies several types of instruments that investors might use in lieu of MMFs, and proffers a list of twelve “Cash Investment Alternatives” with an overview of their valuation, investment risks, redemption restrictions, yields, regulatory profiles, etc. The list includes such alternatives as bank accounts, offshore MMFs, separately managed accounts, and direct investment in money market instruments.

We must be realistic. Most investors will not really have a choice. Those that leave MMFs because they no longer have a stable value will move their assets to other products that have a stable value. This cuts the Commission’s list by seven, leaving five potential destinations

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<sup>93</sup> Letter from Blackrock to SEC (Sept. 11, 2013) (available in File No. S7-03-13).

<sup>94</sup> *Id.*

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for MMF assets: bank deposits, some offshore MMFs, some private “enhanced cash” funds, bank-administered short-term investment funds (STIFs), and local government investment pools (LGIPs).

Of course, LGIPs are only open to state and local government entities. Privately offered “enhanced cash” funds are not transparent, and are not subject to thorough regulatory oversight.<sup>95</sup> As to offshore funds, even the word “offshore” is enough to deter most treasurers and Boards, and as the Commission notes “as a practical matter, and in view of the severe consequences of violating the Securities Act registration and offering requirements, most European money market funds currently prohibit investment by U.S. Persons.”<sup>96</sup>

This leaves bank products. Of these, STIFs are only available to a bank’s trust and fiduciary clients and certain types of qualified employee benefit plans. STIFs are also less transparent to investors, and are not as tightly regulated as MMFs. Thus, it appears that a likely destination for much of the short-term liquidity balances currently invested in MMFs will be bank deposits.

This is consistent with history. Figure 5 below, taken from a Report by the Commission’s Division of Risk, Strategy, and Financial Innovation confirms that investors are most likely to shift their MMF assets to banks, showing a nearly dollar-for-dollar shift in cash held by non-financial business from MMFs to checkable bank deposits from 2008 to 2011.<sup>97</sup>

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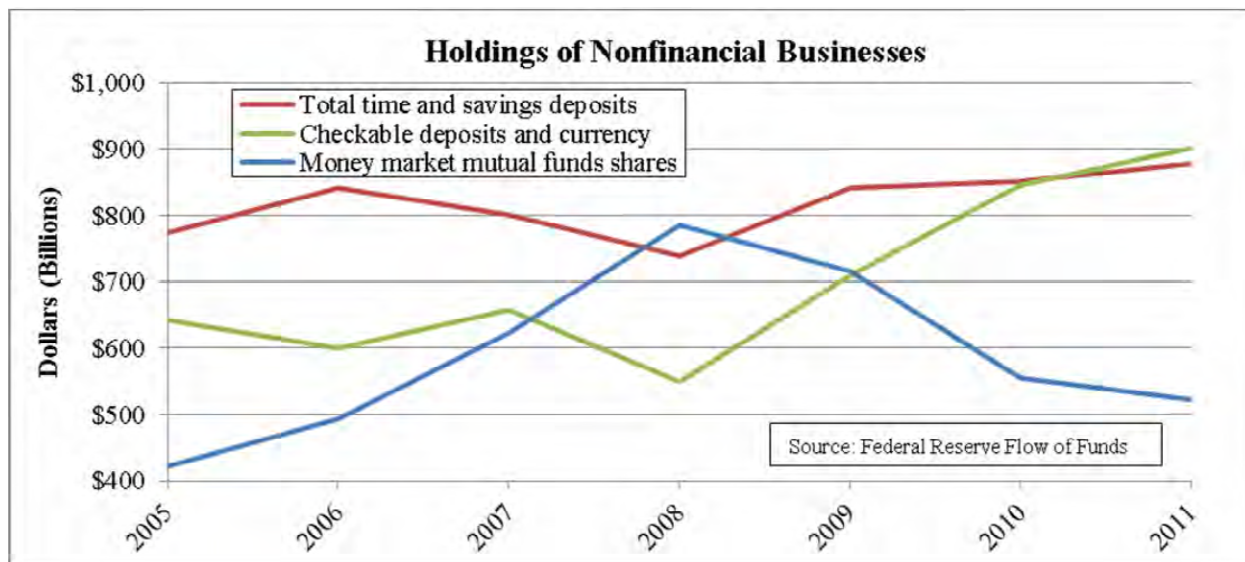
<sup>95</sup> See SEC Division of Risk, Strategy, and Financial Innovation, Response to Questions Posed by Commissioners Aguilar, Paredes, and Gallagher (Nov. 30, 2012) at 45; Release at 36917.

<sup>96</sup> Release at 36917, note g.

<sup>97</sup> SEC Division of Risk, Strategy, and Financial Innovation, Response to Questions Posed by Commissioners Aguilar, Paredes, and Gallagher (Nov. 30, 2012) at 46.

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**Figure 5**  
**Assets of Non-Financial Businesses**

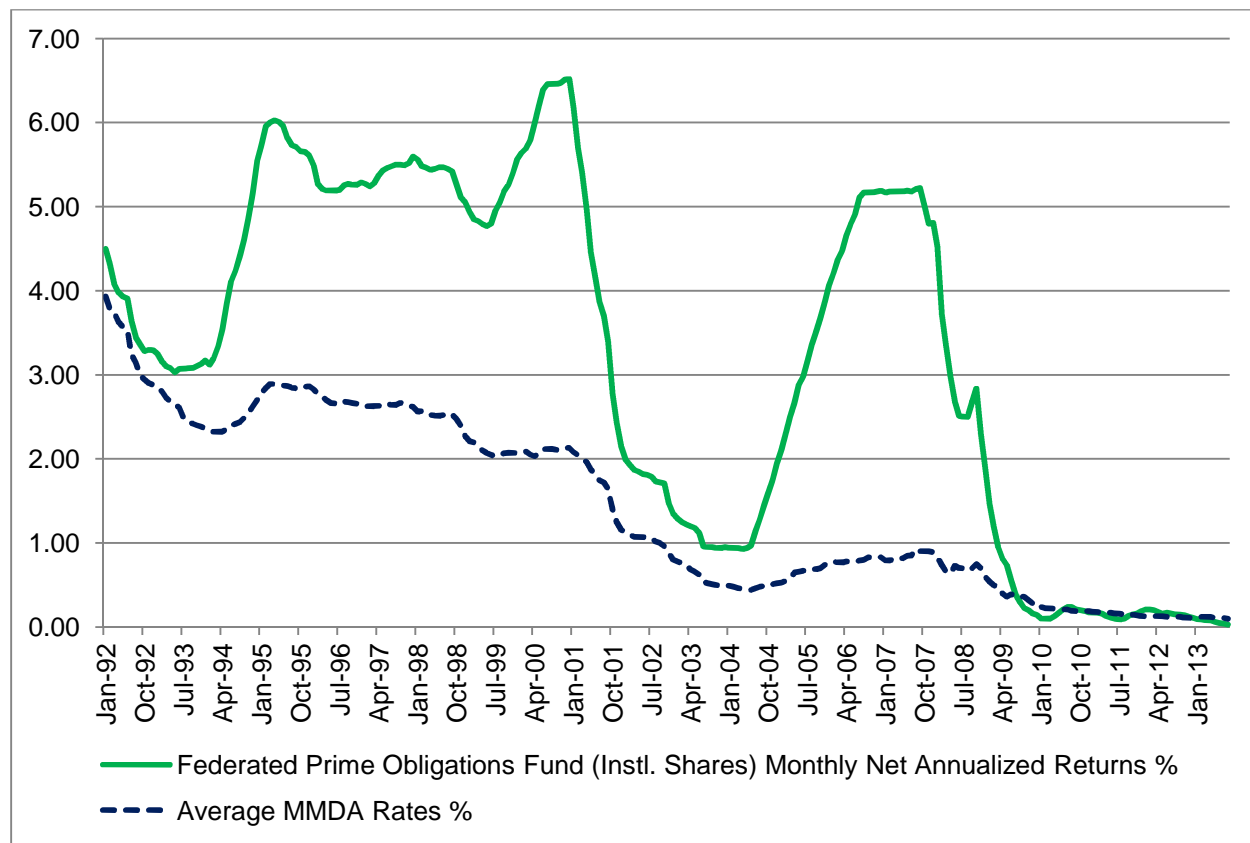


Historically, MMFs have provided a superior rate of return compared to bank deposits. Using data from the Investment Company Institute, iMoneyNet and the Bank Rate Monitor, Federated estimates that, during the period from 1985 through 2008, taxable MMFs increased investor returns by over \$450 billion as compared to what the same assets would have earned in money market demand accounts. The historical spread of net prime MMF yields over bank money market demand account rates has exceeded 150 basis points over substantial periods of time.

To illustrate, Figure 6 shows the annualized monthly return on institutional class shares in Federated's Prime Obligations Fund (POF) compared with the average rate paid by banks on money market demand accounts. From 1992 through 2009, POF consistently provided a higher return than an MMDA. In fact, over this time period, POF increased investor returns by \$5.2 billion over what their assets would have earned in the average MMDA. (Since 2009, the extraordinarily low short-term interest rates established by the Federal Reserve in response to the fallout of the 2007-2009 financial crisis have temporarily suppressed MMF yields and reduced this investor benefit. But the investor earnings benefit from MMFs will return in the future, as rates inevitably will climb after the Federal Reserve pulls back from its five-years of quantitative easing).

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**Figure 6**  
**Prime Obligations Fund's Monthly Return vs.**  
**Average MMDA Rate (1992-2013)**



These higher returns are due to the differences between banks, which pay enormous amounts for physical facilities and salaries, and MMFs, which have considerably less overhead. A comparison of expense data shows that the cost differential between MMFs and banks is between 200 and 300 basis points per year per dollar of assets. This large cost differential between the expense ratios of MMFs as compared to banks means there are lower returns to savers when balances are intermediated through the banking system.

Investments shifted to government MMFs would also earn lower returns for investors. The cost to prime institutional MMF investors who shift assets to government MMFs may be estimated by reference to the average historical yield spread of prime funds over government funds: 15 – 20 basis points (0.15% – 0.20%). To illustrate, if the minimum \$660 to \$750 billion

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that we believe will flow out of institutional prime MMFs were to enter government funds, lost investment returns would total \$990 million to \$1.5 billion annually. This estimate takes no account of the likely reduction in government fund yields that would accompany the additional demand for these funds. The estimate of \$990 million to \$1.5 billion annually is therefore the low-end minimum for what will be the total annual loss of return to shareholders. The estimate also takes no account of the loss of return, or increase in taxation, that would result from at least \$54 billion in institutional assets exiting tax exempt MMFs.

***B. Creating Bottlenecks in the Payment System.***

The processing delays resulting from movement away from amortized cost to value MMF portfolios and establish share prices would result in fewer daily settlements of redemptions. Settlements would also occur later in the day, and be compressed into a short period immediately prior to the close of Fedwire and other payment systems. This would create unnecessary payment delays, in some cases delaying settlement to the following morning, and make it more difficult to coordinate settlement times of MMF redemptions and purchases with related cash inflows and disbursements to investors. Worse, it increases overnight payment fails, extends counterparty risks, and creates the possibility of a cascading effect of cash shortfalls moving through the payment system and ultimately the financial markets as each successive recipient of the proceeds of the redemption experiences a delay in receipt of cash intended to be used to make a payment.

***C. Effects on Systemic Stability.***

At present, there are approximately \$1.5 trillion invested in prime MMFs (with approximately \$930 billion in institutional and \$540 billion in retail), \$266 billion invested in tax-exempt MMFs (with approximately \$72 billion in institutional and \$195 billion in retail) and \$929 billion in government funds.<sup>98</sup> We also know how many assets each MMF holds, and we know which instruments each of those MMFs hold. We know these facts due to the Commission's disclosure requirements. The Commission's MMF disclosure and reporting rules, which were enhanced in 2010, have created what is perhaps the world's most transparent disclosure regime.

Unfortunately, we also know that many of the assets that are held in MMFs that are subject to this transparent system will be shifted to areas that are less transparent, and that would

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<sup>98</sup> Investment Company Institute: Money Market Mutual Fund Assets (Sept. 12, 2013) (available at [http://www.ici.org/research/stats/mmf/mm\\_09\\_12\\_13](http://www.ici.org/research/stats/mmf/mm_09_12_13)) (includes institutional and retail assets).

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increase systemic risk.<sup>99</sup> As noted above, a substantial percentage of assets shifted from floating NAV MMFs may move to bank deposits, and in particular, to the largest banks. A large transfer of assets to these institutions has serious implications.<sup>100</sup>

First, investments of banks are not as transparent as those of MMFs. It is therefore harder for investors and regulators to gauge systemic risk when investors shift assets to banks. In addition, even bank regulators acknowledge that, for large balances in excess of FDIC deposit insurance limits, MMFs are safer than bank deposits, which represent undiversified and unsecured exposures to a bank.<sup>101</sup> Some investors may take advantage of federal deposit insurance by allocating cash deposits below the deposit insurance limits among multiple banks,<sup>102</sup> but this is an expensive, administratively complex undertaking. In any case, some investors will simply deposit funds with a bank in excess of the deposit insurance limits. These investors will remain exposed to the risk of the bank's failure and will have an incentive to rapidly withdraw their deposits at any hint of such a risk.

Second, a flow of assets to the largest banks would concentrate risks in that sector.<sup>103</sup> Again, the Report by the Commission's Division of Risk, Strategy, and Financial Innovation confirms that investors are most likely to shift their MMF assets to banks.<sup>104</sup> In this vein, over

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<sup>99</sup> While the following discussion describes the implications of an asset shift to banks, we note that no products identified by the Commission as MMF alternatives afford the degree of transparency to investors, regulators and counterparties that MMFs offer. It is therefore easier for investors, regulators, academics and others to assess risk levels in short term markets that feature robust MMF involvement.

<sup>100</sup> Professor Jonathan Macey (Yale Law School) has provided a detailed assessment of this risk. See *Money Market Funds: Vital Source Of Systemic Stability* (2012).

<sup>101</sup> Federal Reserve Bank of New York Staff Report, *The Minimum Balance at Risk: A Proposal to Mitigate the Systemic Risks Posed by Money Market Funds* at 52 (July 2012), <http://www.federalreserve.gov/pubs/feds/2012/201247/201247pap.pdf> ("Even bank deposits have safety disadvantages for large institutional investors whose cash holdings typically exceed by orders of magnitude the caps on deposit insurance coverage; for these investors, deposits are effectively large, unsecured exposures to a bank. MMF shares—which represent claims on diversified, transparent, tightly regulated portfolios—would continue to offer important safety advantages relative to bank deposits [even if the regulatory structure of MMF were altered].") (FRBNY Staff Report).

<sup>102</sup> Certain consulting firms design specific arrangements for this purpose in exchange for a fee.

<sup>103</sup> See Letter from Independent Directors Council and Mutual Fund Directors Forum to Commission (May 2, 2012); Letter from Fidelity Investments to IOSCO, filed with Commission (May 30, 2012); Letter from the Financial Services Roundtable to Commission (Jun. 30, 2011); Letter from New York Business Council to Commission (Jan. 14, 2011).

<sup>104</sup> SEC Division of Risk, Strategy, and Financial Innovation, Response to Questions Posed by Commissioners Aguilar, Paredes, and Gallagher (Nov. 30, 2012) at 46.

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75% of deposit growth in 2011 that was caused by unlimited deposit insurance of demand deposit accounts flowed into the ten largest banks.<sup>105</sup> In 2011, the ten largest U.S. banks also represented 65% of banking assets.<sup>106</sup> As of September 4, 2013, the ten largest banks now represent over 80% of banking assets. If 75% of the estimated \$660 billion to \$750 billion that would be shifted from institutional prime MMFs flows into the ten largest banks, it would increase their total size by \$495 to \$562.5 billion, so that they would represent about 87% of U.S. banking assets.<sup>107</sup> “Too-big-to-fail” banks are already the main source of systemic risk to the financial system. Yet, the consequences of the Commission’s proposed reforms would actually foster the growth of these financial institutions and the expansion of the federal government safety net of deposit insurance, government lending, and periodic bail-outs by taxpayers that is required to maintain them.<sup>108</sup> In this fashion, Alternative One might (in theory) reduce systemic risk in MMFs, but would definitely increase it in the banking system. Increasing the size of the federal safety net was not the purpose of Dodd-Frank, the express purpose of which was to “promote the financial stability of the United States by improving accountability and transparency in the financial system, to end ‘too big to fail’ [and] to protect the American taxpayer by ending bailouts.”<sup>109</sup>

Third, an influx of deposits will have significant and potentially undesirable consequences for banks themselves. For instance, under a 6% leverage capital standard, banks would need to raise enormous amounts of new capital to reflect the growth in bank assets. Bank assets would increase as a result of: (i) increased lending necessary to fund issuers who are

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<sup>105</sup> FDIC Press Release, Insured Institutions Earned \$35.3 Billion in The Third Quarter of 2011 (Nov. 22, 2011); FDIC Quarterly Banking Profile, Vol. 3, No. 1, at 4 (Dec. 31, 2008) (noting that total deposits increased by \$307.9 billion (3.5%) in the fourth quarter of 2008, the largest increase in ten years), <http://www2.fdic.gov/qbp/qbpSelect.asp?menuItem=QBP>.

<sup>106</sup> Richard W. Fisher, President, Federal Reserve Bank of Dallas, Remarks before Columbia University’s Politics and Business Club: Taming the Too-Big-to-Fails: Will Dodd-Frank Be the Ticket or Is Lap-Band Surgery Required? (Nov. 15, 2011), <http://dallasfed.org/news/speeches/fisher/2011/fs111115.cfm>.

<sup>107</sup> This calculation assumes that, over time, the total volume of bank deposits in the system adjusts to reflect a relative increase in investor preference for demand deposits.

<sup>108</sup> The Commission’s staff acknowledged this point. Division of Risk, Strategy and Financial Innovation, Response to Questions Posed by Commissioners Aguilar, Paredes, and Gallagher at 45 (Nov. 30, 2012) (“The shift to bank deposits would increase reliance on FDIC deposit insurance and increase the size of the banking sector, which raises additional concerns about the concentration of risk in the economy.”). *Accord* Letters from Fidelity Investments to IOSCO, filed with Commission (May 30, 2012) (available at File No. 4-619); Letter from Fidelity Investments to Commission (Jan. 10, 2011) (available at File No. 4-619); Letter from Invesco to Commission (Jan. 10, 2011) (available at File No. 4-619); Letter from Professor Jonathan Macey to Commission (Jan. 8, 2011) (available at File No. 4-619).

<sup>109</sup> Preamble to the Dodd-Frank Wall Street Reform and Consumer Protection Act.

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displaced from the commercial paper market; and (ii), any increase in the overall size of the banking system resulting from shareholders that increase their use of demand deposits as a result of the proposed regulations. We estimate that the increase in bank lending alone could necessitate an additional \$12 billion to \$15 billion in bank capital. The Commission's Release does not attempt to calculate the sums that would be needed for this purpose, although it is readily calculable. Further, the infusion of large short-term deposits from institutions would be similar to banks accepting many billions of dollars in new "hot money" brokered deposits, which could have a destabilizing effect on many banks. These large deposits may also surpass a given bank's ability to profitably invest the money, expose the bank to greater interest rate risk and funding risk, raise Federal Reserve required reserve balances and increase FDIC deposit insurance premium assessments. We must recall that only recently some banks responded to large inflows of cash with negative interest rates – charging depositors to leave their money with banks. These multiple effects have not been considered and must be analyzed before the Commission implements the fundamental changes that would cause them.

***D. Increasing the Cost of Capital.***

MMFs hold almost 40% of outstanding commercial paper, and roughly two-thirds of short-term state and local government debt.<sup>110</sup> In December 2012, prime MMFs held about 46% of all financial company commercial paper.<sup>111</sup> Regulatory changes that eliminate or reduce the utility of MMFs for users would necessarily contract the market for, and raise the costs of, short-term public and private debt financing. Dozens of commenters have specifically stated that forcing MMFs to adopt a floating NAV would have this effect. For example, a letter co-signed by 22 diverse companies and organizations, representing a broad range of industries and entities that rely on MMFs to support their capital raising and investment needs by purchasing their commercial paper, warned that:

American business will lose one of its most important sources of short-term funding if money market funds are forced to abandon their stable per-share value, whether directly or indirectly . . . . With such a change, the expected flight of investors from these funds will severely impair the ability of companies to raise capital in the U.S. and undermine efforts to strengthen the American economy. . . . There are no immediate substitutes for money market funds in this financing role. Bank lending cannot fill this funding gap unless banks raise substantial new capital. . . . Mandating a floating NAV would make short-term financing for American business

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<sup>110</sup> Report of the Presidents Working Group on Money Market Fund Reform, at 7.

<sup>111</sup> Release at 36921.

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less efficient and far more costly, ensuring a severe setback for an economy emerging from recession.<sup>112</sup>

A letter signed by 33 Members of Congress, all of whom are former state and local officials further stated, “[a]ny reduction in demand for money market funds would reduce demand for the securities issued by state and local governments and purchased by MMFs. As a result, states and municipalities would be deprived of a critical funding source and would be faced with increasing debt issuance costs.”<sup>113</sup>

The Commission has attempted to estimate the impact of its proposals on the commercial paper markets and municipal financing. Two weaknesses undermine those estimates. First, the Release acknowledges that the Commission “currently do[es] not have estimates of the amount of assets money market fund investors might migrate to investment alternatives.”<sup>114</sup> Second, while the Release attempts to assess the impact of the proposals on the short-term debt markets, it focuses on the period between 2008 and 2012. This is not an appropriate timeframe for this purpose, due to the effects of the Federal Reserve’s policy of quantitative easing and the lingering fallout of the 2007-2009 crisis. After all, the reductions in funding demand by municipalities and other issuers<sup>115</sup> may reflect the generally sluggish economy or other factors, rather than the normal impact of MMFs on the short-term debt markets. The current environment of exceptionally low interest rates, quantitative easing and highly accommodative monetary policy make recent data an unreliable guide for evaluating the full consequences of the proposed reforms.

In any case, Federated believes that, at a minimum, from \$660 billion to \$750 billion in institutional prime MMF assets, and \$54 billion in institutional tax-exempt MMF assets, will be driven to other short-term vehicles. If MMFs are diminished in the short-term debt markets by such large amounts, issuers will be forced to pay higher interest, extend the durations of their debt burdens, and/or resort to bank lending. Banks are not likely to supply that credit on as good terms.

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<sup>112</sup> Letter from Agilent Technologies, Inc., Air Products & Chemicals, Inc., Association for Financial Professionals, The Boeing Company, Cadence Design Systems, CVS Caremark Corporation, Devon Energy, Dominion Resources, Inc., Eastman Chemical Company, Eli Lilly & Company, Financial Executives International’s Committee on Corporate Treasury, FMC Corporation, Institutional Cash Distributors, Kentucky Chamber of Commerce, Kraft Foods Global, Inc., National Association of Corporate Treasurers, New Hampshire Business and Industry Association, Nissan North America Inc., Pacific Gas and Electric Company, Safeway Inc., Weatherford International, Ltd., U.S. Chamber of Commerce to Commission (Jan. 10, 2011) (available in File No. 4-619).

<sup>113</sup> Letter from 33 Members of Congress to Commission (May 1, 2012).

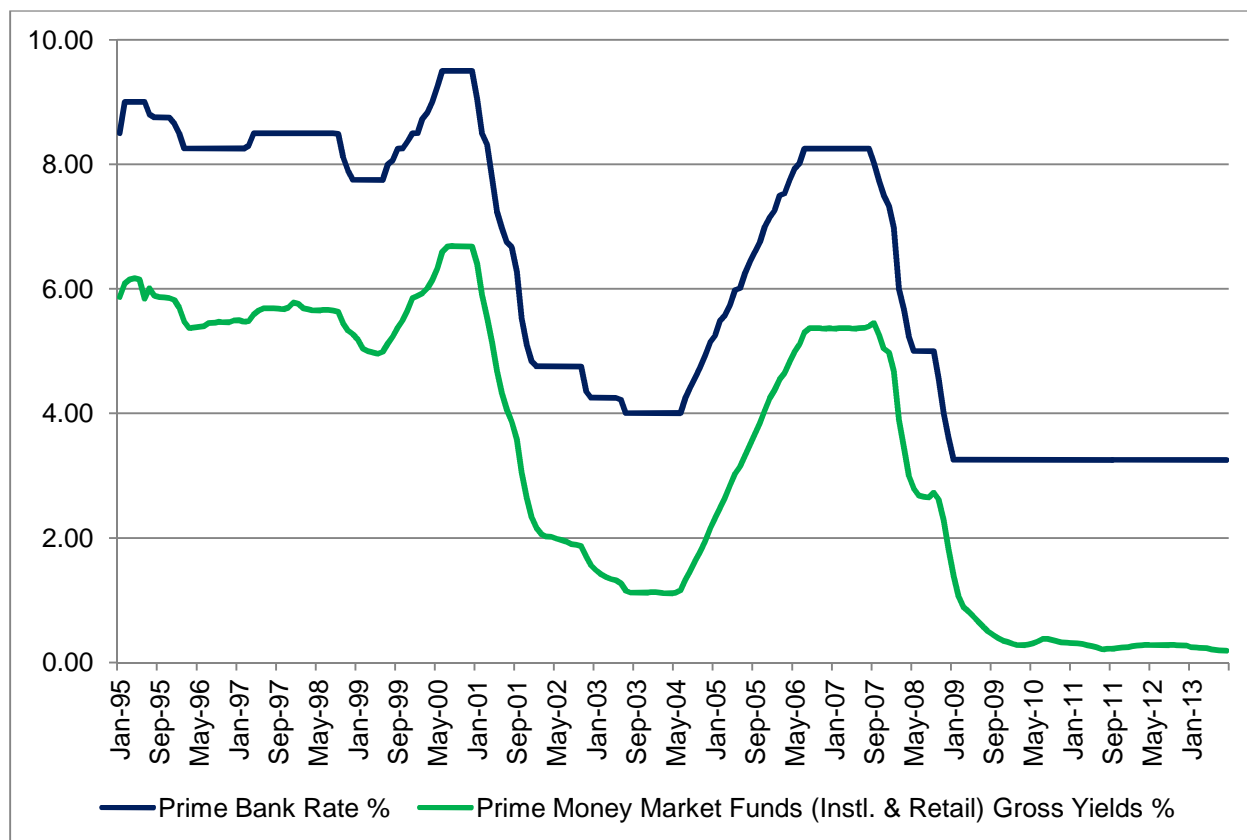
<sup>114</sup> Release at 36920.

<sup>115</sup> *Id.* at 36921-22.

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Figure 7 illustrates the historical spread of the prime rate charged by banks over the average gross yield charged by prime MMFs. The current prime bank lending rate of 3.25% compared with prime commercial paper rates of 12 to 27 basis points illustrates the increase in borrowing costs that today's prime issuers could face. These greater intermediation costs would produce a dead weight loss to the economy.

**Figure 7:**  
**Spread of Bank Prime Rate over Prime Money Market Fund Gross Yields**



The majority of the issuers in the money markets are of relatively small size and are not well known, except to firms – primarily MMFs – that have specialized credit research departments. Federated estimates that over one-half and possibly as many as two-thirds of prime, asset-backed commercial paper, and municipal issuers would no longer have direct access to the money markets if the Commission adopts Alternative One. The Release acknowledges that since 2008, municipalities have already increased borrowing from depositories by \$142 billion, at unknown cost. It is therefore reasonable to expect that more municipalities and other smaller issuers will be forced to borrow in the short term from banks (or other more costly

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lenders). As a result, these issuers can expect to pay up to 300 basis points more in borrowing costs than they otherwise would pay.

With regard to commercial paper rates, historically, prime MMFs purchased an average of 40% of commercial paper issuance. This amount could be cut by at least one-half under the proposed Alternative One. An increase in prime commercial paper spreads in the range of 10 to 20 basis points is therefore reasonable, especially in light of the future normalization of credit conditions from today's extraordinarily accommodative Federal Reserve stance and a recovery in financial sector activity. In sum, as a result of the higher bank lending and commercial paper rates, the imposition of Alternative One will produce an overall increase in private sector borrowing costs in the range of approximately \$5 billion to \$8 billion annually.

***E. Need for Further Inquiry.***

The Release provides a somewhat speculative discussion of the outcomes that may or may not result from the Commission's proposals. In a few places, it provides a discussion of the potential costs and benefits, but it does not begin to satisfy the requirements of an adequate cost/benefit analysis, and it certainly does not demonstrate benefits that justify the costs identified in this comment. Broad, unquantifiable recitations that the rule changes are "intended to mitigate" or "should reduce" a future unknown systemic risk do not suffice for the imposition of rules that will severely stifle growth, efficiency, competition and capital formation.

In this regard, the Commission has not identified risks that would not be addressed by Alternative Two that could only be addressed by Alternative One. That is, the Commission has not substantiated that any risks that remain after the implementation of rules that would permit the temporary imposition of liquidity fees, or the temporary suspension of redemptions, would warrant the required use of a floating NAV. The legal directives that apply to and guide the Commission compel the conclusion that it must employ all reasonable means at its disposal to identify targeted and cost-justified remedies. The Commission must identify specific outcomes that less costly alternatives do not address before considering requirements that are more burdensome.

Thus, the Commission may not impose damaging reforms beyond Alternative Two based on vague and unsubstantiated assertions. Rather, it must determine whether the risks that it has identified would exist in an environment where Alternative Two has been implemented. In this vein, in its November 2012 study, the Commission's Division of Risk, Strategy, and Financial Innovation, introduced a new and powerful methodology in order to answer specific questions posed by various Commissioners.<sup>116</sup> This same methodology may be employed to answer

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<sup>116</sup> *Response to Questions Posed by Commissioners Aguilar, Paredes, and Gallagher* (Nov. 30, 2012).

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whether there are any questions relating to shareholder and advisor behavior that Alternative Two by itself may not address. Specifically, the Commission must, among other things, use this model to analyze the specific market, redemption, and advisor behaviors that may occur under circumstances in which Alternative Two has already been adopted.

We also note that, although the proponents of Alternative One frequently use a term drawn from game theory (the so-called “first mover advantage”) to support their arguments for major structural changes to MMFs, no one has published a rigorous peer-reviewed analysis using game theory precepts of MMF redemptions and the efficacy of the two Alternatives in addressing incentives for MMF shareholders to redeem. One classic game theory analysis of bank runs concludes that “suspension of convertibility” of bank deposits (analogous to temporarily suspending MMF redemptions as contemplated by Alternative Two) can be a very effective tool in addressing bank runs.<sup>117</sup> Until the Commission and others have thoroughly and rigorously analyzed game theory arguments in their own terms in a way that can withstand scrutiny, game theory buzzwords cannot be relied upon by the Commission in adopting major structural changes to MMFs.

#### **IV. Conclusion.**

The hard truth is that moving to a variable NAV for a large subset of MMFs and imposing burdensome requirements on another large subset of MMFs, as contemplated by Alternative One, and abandoning amortized cost in valuing portfolio assets as contemplated under both Alternatives, does nothing to achieve the policy objective of stopping the potential for a run on MMFs in a future financial crisis. There is no real benefit to these parts of the proposal. The costs, in contrast, are very tangible and vast.

Federated does not believe that the case has been made that further change to MMF regulation is necessary at this time. In particular, Federated does not believe the case has yet been made that these central elements of Commission’s proposal meet the cost/benefit and other economic tests required of a rulemaking under the federal securities laws, the APA, Executive Orders and Commission policies.

To the extent that the Commission bows to pressure from the FSOC and determines that it should implement structural reform for MMFs, Alternative Two is far less damaging and

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<sup>117</sup> See D. Diamond & P. Dybvig, *Bank Runs, Deposit Insurance, and Liquidity*, reprinted in 24 Federal Reserve Bank of Minneapolis Quarterly Review No. 1 (Winter 2000) at 14, 19-20. Notably, banks have far lower portfolio liquidity, far higher portfolio risk, and far less portfolio transparency, than do MMFs, which greatly exacerbates run risks at banks and are factors recited in the article as creating a policy basis for FDIC insurance to support banks with a Federal safety net. Unlike banks and hedge funds, MMF portfolios are open books, not black boxes.

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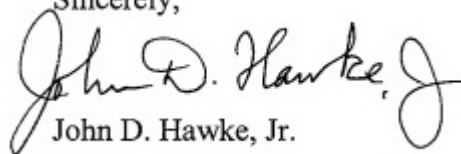
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costly to investors and the economy than is Alternative One. Revisions to Alternative Two, to: (a) keep the amortized cost method, (b) reduce the weekly liquid assets threshold for triggering liquidity fees or temporary suspensions of redemptions from 15% to 10%, (c) reduce the maximum period that redemptions may be suspended to ten calendar days, and subject liquidity fees to the same limitation; (d) permit directors to implement a liquidity fee or suspend redemptions temporarily *before* the end of the business day, so the board can respond to situations in which unimpeded redemptions are likely to impair a fund's liquidity or the Board otherwise determines that such redemption restrictions are in the best interest of shareholders, together with (e) a clear statement from the Commission that liquidity fees and gates are to be applied only rarely in extreme circumstances to stop runs and protect MMF shareholders from unfair results, would further reduce the cost and burdens of Alternative Two while preserving its potential usefulness to stop a run on a MMF in a future crisis.

Imposing both Alternatives One and Two would be the worst possible decision. Alternative One would be nearly as bad, and would result in a substantial shrinkage of MMFs and impose massive costs, inefficiencies and burdens that are inherently contrary to the interests of investors, markets, capital formation, competition, efficiency or financial system stability. The benefits, if any, would flow from Alternative Two in providing an additional set of tools to MMF boards to address liquidity issues from sustained redemptions.

The purpose of a cost-benefit approach to rulemaking is to benefit the public by not needlessly imposing costs and burdens that outweigh the resulting benefits to investors, markets and the economy. Where the Commission is considering alternatives that are less costly and work more effectively, and weighing them against other alternative that would be extraordinarily costly, disruptive and impose risks and inefficiencies without achieving the desired policy objectives, it would be arbitrary and capricious and an abuse of discretion to adopt the more burdensome and less effective alternative.

Sincerely,



John D. Hawke, Jr.