

November 21, 2013

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

Re: **Proposed Rule on *Money Market Fund Reform*; Amendments to Form PF;  
Release No. S7-03-13**

Dear Chair White:

This letter is filed on behalf of Federated Investors, Inc., and its subsidiaries (“Federated”), as a further response to the Commission’s request for comment on its proposed rule on *Money Market Fund Reform; Amendments to Form PF* (the “Release” or “Proposal”).<sup>1</sup>

For nearly 40 years, Federated has provided money market mutual funds (“MMFs”) and related services to a diverse investor base, which includes a significant number of institutions. These institutions owe a fiduciary duty to the millions of investors and other customers on whose behalf they facilitate transactions, safeguard assets, and are obligated to invest prudently. As the Commission is aware, institutional investors in MMFs are the primary target of the Commission’s reform proposals, particularly the floating net asset value (“NAV”) proposal in Alternative One, which would severely impair their use of MMFs on a day-to-day basis and limit their options for short-term investment of cash. Thus, if the proposal is adopted, these investors

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<sup>1</sup> 78 Fed. Reg. 36834 (June 19, 2013) (“Release”). Federated and its counsel previously have filed twelve comment letters in the rulemaking in an effort to focus on particular substantive issues raised by the Commission in the Release. The Release generated 1,444 comment letters, 221 of which are viewed by the Commission as individually distinct, 1,223 others of which are viewed as form letters. This latter group of commenters includes individuals and business executives from a range of industries, including banks, trust companies, broker dealers, investment advisers, and corporations throughout the United States, as well as state and local government officials. The comments filed in the current rulemaking are in addition to the 128 letters filed in response to the Financial Stability Oversight Council’s *Proposed Recommendations Regarding Money Market Mutual Fund Reform*, 77 Fed. Reg. 69455 (Nov. 19, 2012) (“Proposed Recommendations”) and the 2,503 letters filed in response to the Commission’s request for comment on the *President’s Working Group Report on Money Market Fund Reform*, 75 Fed. Reg. 68636 (Nov. 8, 2010). Many of these letters include surveys, reports, research and other analyses related to the various money market fund (“MMF”) reform proposals.

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will experience substantial disruptions and extraordinary costs, which, in turn, will raise costs and limit investment and cash management choices for millions of investors.

Federated is committed to the investors in its MMFs and believes the preservation of MMFs for all investors requires the significant effort Federated has made, and will continue to make, to inform the debate. Numerous commenters have expressed strong concerns to the Commission that its proposals, in their current form, are misguided and would not preserve MMFs for a very large group of investors. As discussed below, we believe a reading of the current comment file should lead the Commission to reject the floating NAV proposal in Alternative One and work to further enhance Alternative Two, as the only means to achieve the Commission's stated reform goals.

Parts I through IV of the attached Appendix present the views of commenters on various aspects of the Commission's proposals. Part V of the Appendix discusses the views of commenters on the systemic consequences and costs of the proposals, which we know will be substantial but which have not yet been fully assessed. As further discussed in Part VI of the Appendix, the Commission should not impose structural reforms on MMFs until it has fully assessed the economic impact of its proposals. This economic assessment should evaluate the Commission's proposals in the context of the continued implementation of the Dodd-Frank Act and other regulatory initiatives that directly address the risks posed by banks' reliance on short-term funding,<sup>2</sup> including sources of systemic risk and appropriate regulation; the effects of crowding out; impacts on the yield curve; effects on bridge financing; adverse impacts on market behavior; the need for a game-theoretic formulation of investor behavior; and the impact of the proposals on efficiency and competition. These issues are discussed on pages 62-68 of the Appendix.

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<sup>2</sup> For example, the recently proposed Liquidity Coverage Ratio (LCR) for banking organizations would directly address these concerns by establishing the first quantitative liquidity requirement ever imposed on banking firms in the U.S. If adopted, the LCR proposal would eliminate the justification for changing the structure of MMFs as an indirect means to address bank short-term funding risks. Press Release, Board of Governors of the Federal Reserve System (Oct. 24, 2103), <http://www.federalreserve.gov/newsevents/press/bcreg/20131024a.htm>; Joint Press Release, Office of the Comptroller of the Currency and Federal Deposit Insurance Corporation, "OCC and FDIC Propose Rule to Strengthen Liquidity Risk Management," NR 2013-169 (Oct. 30, 2013), <http://www.occ.treas.gov/newsissuances/news-releases/2013/nr-ia-2013-169.html> and <http://www.fdic.gov/news/news/press/2013/pr13096.html>.

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### **Commenters' Positions on the Proposal.<sup>3</sup>**

The Floating NAV Proposal, Alternative One. To date, the Commission has received letters from 1,431 commenters,<sup>4</sup> 1,381 of which voice direct opposition to or raise serious questions regarding the floating NAV proposal in Alternative One for a variety of reasons, including that it:

- Is ineffective in meeting the Commission's stated goals;
- Is unnecessary to meet those goals in light of other, more effective and less costly alternatives;
- Is so destructive of the essential features of MMFs required by investors that investors will not use the product;
- Presents unworkable carve outs and exemptions that add to investors' and intermediaries' burdens and costs but which are ineffective in achieving the Commission's stated intent;
- Adds to systemic risk by driving investors to the largest banks or less transparent and less regulated products; and
- Undermines efficiency, capital formation, and competition by lowering yields for investors and raising costs for users and issuers.

Many of these commenters stated that they and/or their investors *will not use*, or will *substantially reduce* their use of, MMFs if the floating NAV were adopted; many of these commenters predicted that there would be substantial reductions in prime and tax exempt MMF

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<sup>3</sup> This letter and the Appendix reference individual comment letters according to abbreviated names, for ease of reading. An alphabetical list of commenters and their abbreviated names is included at the end of this Appendix for the Commission's reference. All comment letters referenced in this Appendix are available in the Commission's comment file for the Release (File No. S7-03-13).

<sup>4</sup> The Commission has posted 221 individual comment letters on its website, and has received an additional 1,223 letters that have not been posted. For purposes of summarizing the number of commenters supporting or opposing the Commission's proposals in this letter, we have excluded duplicates and considered the twelve letters filed by or on behalf of Federated as one letter or commenter, as appropriate, and thus have considered the total number of commenters to be 1,431.

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assets as a result: Moreover, no commenters stated that they would be more likely to invest in MMFs if the floating NAV proposal were adopted, nor did any commenters suggest that funds will flow into MMFs as a result of the change, other than a shift of funds from prime MMFs to government MMFs.

Only 19 comments supported the floating NAV proposal.<sup>5</sup> Many of these supporters nonetheless argued that:

- The Commission must fully resolve tax, accounting and operational issues *before* adopting the proposal;
- The Commission should continue to limit the floating NAV to institutional MMFs (indeed, it is clear that certain of these supporters, the customer bases of which are largely retail, would *oppose* the floating NAV if it were not limited to institutional investors);
- The Commission should not hold institutional MMFs to a more stringent standard for pricing accuracy than other mutual funds (an NAV calculated to the nearest ten basis points rather than the one basis point standard proposed under Alternative One); and
- The Commission should broaden the exceptions currently in the Proposals or create new ones (*e.g.*, raising the daily redemption limit from \$1 million to \$5 million or using a Social Security Number as a means to identify “retail” investors for purposes of the exemption).

The Liquidity Fees and Gates Proposal, Alternative Two. As we have written in prior comment letters, the Commission’s proposed Alternative Two, if carefully tailored along the lines that we and others have suggested and supplemented with disclosure enhancements, is the only proposal that meets the Commission’s stated goals, because it would:

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<sup>5</sup> Those comments were filed by Edward Jones, North Carolina Treasurer, CFA Institute, Better Markets, T. Rowe Price, Goldman Sachs, Committee on Annuity Insurers, Vanguard, Wisconsin Bankers Association, Thrivent, TIAA-CREF, Occupy the SEC, Northern Trust, Systemic Risk Council, SPARK Institute, McCulloch, Federal Reserve, Schwab, and George Blumel. In addition, BlackRock stated that it supports focusing the floating NAV proposal on prime MMFs while exempting government MMFs.

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- Address the potential for heavy redemptions in MMFs and make them more resilient in the face of potential contagion from such redemptions;
- Increase the transparency of their risks in the most cost effective way; and
- Preserve as much as possible the benefits of MMFs for investors and issuers.

A total of 1,259 commenters expressed support for Alternative Two, citing the above and other reasons, although many commenters suggested the types of modifications that have been proposed by Federated in prior comments to the Commission,<sup>6</sup> offered new ones, or supported Alternative Two only as preferable to Alternative One.

Seventy-three commenters opposed Alternative Two, although some of these commenters conceded that it is the only alternative that could effectively halt large-scale redemptions from a MMF.<sup>7</sup> Many argued that it would unnecessarily limit investor access to their funds. Some commenters argued that the proposal could itself precipitate preemptive runs. Federated shares both of these concerns, which is why it has urged the Commission to consider modifying the proposal to address these issues.

Only three commenters supported the approach of combining Alternatives One and Two.<sup>8</sup> A large group of commenters made their views clear that a MMF that is subject to both a floating NAV and liquidity and redemption restrictions would be a product no rational investor would ever buy.<sup>9</sup>

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<sup>6</sup> We briefly discuss these proposed modifications in Part II of the Appendix.

<sup>7</sup> Spectrem Group provided cost information regarding Alternative Two but did not express support or opposition for the proposal itself. ACLI wrote that it opposes Alternative Two unless certain exceptions are included for life insurance products. SIFMA noted that “[m]embers views vary on this fundamental reform.” Northern Trust favored Alternative One with certain modifications, but wrote that if its proposed modifications were not adopted, Northern Trust would favor Alternative Two with a lower liquidity fee. These and the remaining 95 comments that do not address Alternative Two or otherwise could not be categorized are not included in the above totals.

<sup>8</sup> The three commenters who supported a combination of the two proposed Alternatives are Better Markets, TIAA-CREF, and Schwab.

<sup>9</sup> See, e.g., Independent Directors Council, Mutual Fund Directors Forum, Invesco, Dreyfus, Deutsche, Fidelity, Oppenheimer, Wells Fargo, BlackRock, Goldman, State Street, SIFMA, and ICI, among others.

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We understand that the Commission will carefully review and consider the comments and that it will respond to substantial concerns raised by commenters, as it is required to do.<sup>10</sup> Although the Staff will provide its own detailed analysis of the comments for the Commission's consideration, we are providing the attached Appendix in an effort to highlight and summarize certain commentary – quoting directly from the letters filed with the Commission – on the major issues raised by Alternatives One and Two of the Proposal.

The Commission in its Release and Chair White in Congressional testimony and in public statements have assured investors that the Commission seeks to preserve the benefits of MMFs for investors. This is in stark contrast to the goals of current and former bank regulators who have been involved in the reform debate and whose antipathy toward MMFs is long-standing and well-known.<sup>11</sup> MMFs are subject to the regulatory jurisdiction of the Commission, and the Commission is the appropriate body to carefully tailor changes to the regulation of MMFs.<sup>12</sup> The Commission's rulemaking analysis is subject to specific statutory mandates, which other regulators advocating reform have not adequately considered. Indeed, the Commission's need to

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<sup>10</sup> *Business Roundtable v. SEC*, 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>11</sup> *SEC Roundtable on Money Market Funds and Systemic Risk* (May 10, 2011) (statement of Paul A. Volcker) (Suggesting that the 650 MMFs could become banks: “This country could use 650 more banks. We just lost about 1,000 during the crisis.”); *Federal Reserve's First Monetary Policy Report for 2012: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs*, 112<sup>th</sup> Cong. (Mar. 1, 2012) (testimony of Ben Bernanke) (Senator Schumer: “Do you think money market funds play a useful role, though, in the economy and we should try to keep them going?” Mr. Bernanke: “Well, generally speaking, they do, and they are a useful source of short-run money. And, again, please do not overread this, but Europe does not have any, and they have a financial system . . . .”); *Money Market Mutual Funds: Hearing Before the H. Subcomm. on Capital Markets and Gov't Sponsored Enterprises*, 113<sup>th</sup> Cong. (Sept. 18, 2013) (testimony of Sheila Bair) (suggesting in response to questions that a benefit of a floating NAV would be a smaller MMF industry); Thomas M. Hoenig and Charles S. Morris, *Restructuring the Banking System to Improve Safety and Soundness* at 16 (May 2011) (dismissing the adverse consequences of a floating NAV by arguing that even if a fluctuating NAV limits MMFs as a cash management option for large corporations, these corporations can turn to banks), [http://www.banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore\\_id=4c250445-e6e7-411a-a4f3-27e657ab9749](http://www.banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=4c250445-e6e7-411a-a4f3-27e657ab9749).

<sup>12</sup> See Financial Stability Oversight Council, 2013 Annual Report 11 (Apr. 25, 2013), <http://www.treasury.gov/initiatives/fsoc/Documents/FSOC%202013%20Annual%20Report.pdf> (“The SEC, by virtue of its institutional expertise and statutory authority, is best positioned to implement reforms to address the risk that MMFs present to the economy.”).

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choose a regulatory alternative that preserves MMFs for investors is compelled by requirements that it consider the effects of its rules on investor protection, efficiency, competition, and capital formation. In this regard –

- MMFs provide a combination of stability, transparency, low risk, liquidity, competitive yield and regulatory oversight that is unmatched by alternative products, as the Commission itself acknowledges in the Release.<sup>13</sup> They are good for investors.
- MMFs have lowered financing costs for issuers, including state and local governments, as well as private issuers. They are good for capital formation.
- The stable value pricing of MMFs using the amortized cost method closely tracks “market-based” valuations. Neither of these valuation methods represents “mark-to-market” pricing, but the use of the two methods together streamlines and facilitates cash management while providing an important “market” benchmark to assure investor fairness. They promote efficiency while protecting investors.
- The risks, characteristics, and valuations of MMFs are fully disclosed and well-known by investors. MMFs’ transparency further promotes efficiency and fairness.

The Commission, after reviewing the comment file, cannot meet the applicable statutory standards for its rulemaking by approving a rule that would fail to accomplish its reform goals while at the same time would destroy a large segment of MMFs, which have proved so beneficial to investors and issuers. The Commission’s comment file demonstrates that adopting Alternatives One and Two in combination would create a product that no rational investor would select and that would, in the words of one commenter, “lead nearly all investors to choose other options – further exacerbating the costs associated with a massive migration of assets to government money market funds and riskier and less-regulated alternatives.”<sup>14</sup> Commenters also have made it clear that Alternative One, if adopted, would destroy the utility of MMFs for millions of investors and substantially shrink investments in private and municipal short-term debt, without achieving the Commission’s primary reform objectives of reducing the risk of large-scale redemptions during market stress. Quoting one commenter, the floating NAV

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<sup>13</sup> Release at 36917.

<sup>14</sup> Wells Fargo.

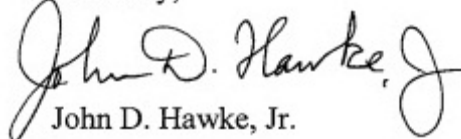
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“completely fails to address MMF run risk.”<sup>15</sup> Alternative Two, in contrast, offers the potential to achieve the Commission’s objectives of addressing run risk and protecting shareholders from material dilution, while also preserving the day-to-day utility of MMFs for investors. We recognize that additional work must be done to refine Alternative Two in order to address the potential for preemptive redemptions, as well as to gain investor acceptance for the proposal. Federated and other commenters have offered proposals in this area.

The Commission’s goal in the adoption of any changes to MMF regulations should be to fulfill its own statutory mandates, not to respond to pressure from other regulators whose mandates do not include, at their core, the protection of investors and the fostering of competition, efficiency, and capital formation in the markets. The Commission certainly should not adopt rules to dramatically restructure MMFs until it has fully assessed both the effectiveness of any proposal in achieving the Commission’s goals, and the impact of any proposal on investors and the economy. We hope these additional materials will be helpful to the Commission as it considers these important issues.

Sincerely,



John D. Hawke, Jr.

cc: The Honorable Luis A. Aguilar  
The Honorable Daniel M. Gallagher  
The Honorable Michael S. Piwowar  
The Honorable Kara M. Stein

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<sup>15</sup> U.S. Bancorp.



## **Appendix**

### **Summary of Comments and Analysis of Additional Economic Impacts**

Although the Staff will provide its own detailed analysis of the comments for the Commission's consideration, we are providing the attached Appendix in an effort to highlight and summarize certain commentary on the major issues raised by Alternatives One and Two of the Proposal, as well as the anticipated economic impact of the Proposal and the need for additional work by the Commission to fully assess the Proposal's impact.

- **Part I, The Floating NAV Proposal.** The vast majority of commenters wrote that the floating NAV would not address the Commission's key policy goal of reducing or eliminating the risk of large-scale redemptions. Many commenters emphasized that such a fundamental change is wholly unnecessary to make the risks of investing in MMFs more transparent to investors. Commenters described substantial operational, tax, accounting and legal burdens associated with a floating NAV that are not fully resolved by the proposal. Commenters also described the impact of the elimination of the amortized cost method of valuation on pushing back settlement times and increasing new risks and investor confusion. Commenters further discussed the failure of the proposed exemptions for retail and government funds to resolve these issues. Commenters who expressed support for the floating NAV proposal generally were not adversely impacted by it, or suggested modifications to the proposal to minimize the impact they or their customers would encounter.
- **Part II, The Fees and Gates Proposal.** Many commenters wrote that the fees and gates proposal is the only proposal that would accomplish the Commission's intended goals; others raised concerns regarding the costs and impact of the proposal, as currently formulated. Proposals by Federated and others would address these concerns.
- **Part III, Impact on State and Local Governments.** State and local governments represent a substantial number of commenters; they and other commenters argue that state and local governments, both as investors in MMFs and as issuers, would be needlessly hard hit by the proposals.
- **Part IV, Other Elements of the Commission's Proposals.** Commenters' views on the Commission's proposed disclosure, diversification, and stress testing requirements varied; many agreed that while the proposals contain useful elements, some aspects of some provisions would be excessively costly and burdensome without a corresponding benefit to investors or to systemic stability.
- **Part V, The Consequences and Costs of the Proposals.** A number of commenters estimated the substantial costs that would be incurred to modify systems and

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processes to comply with the proposals. Many commenters stated that the proposals would reduce the use of MMFs as vehicles for investment and cash management, and that this would result in a diminished role for MMFs in the financial system, a shift of assets to other less regulated or less transparent vehicles, and higher short-term capital costs.

- **Part VI, Additional Economic Analysis.** This section identifies additional areas of economic analysis that the Commission has not reviewed and which should be assessed before adoption of any rule changes.

## **I. Alternative One – The Floating NAV Proposal**

- A. Commenters overwhelmingly stated that the floating NAV will not accomplish the Commission’s goals of mitigating run risk or providing additional transparency.**

### **1. Impact of a Floating NAV in Mitigating Run Risk**

An overwhelming number of comment letters, data, surveys, and other material in the Commission’s extensive comment file, developed in the current rulemaking and over the past three years, reject the proposition that a floating NAV would prevent or reduce the potential for large scale redemptions from MMFs in a crisis or in response to a significant credit event. Indeed, academics, users, service providers, and most fund sponsors agree that it will not reduce or prevent large scale redemptions or a flight to safety in a crisis.<sup>16</sup> The Commission has conceded this point in its Release, as have other regulators who are advocates of the floating NAV.<sup>17</sup> Arnold & Porter’s September 13, 2013 letter on behalf of Federated addresses this issue

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<sup>16</sup> See Mutual Fund Directors Forum, Association for Financial Professionals, American Bankers Association, ICI, Angel Research Paper, Chamber-CCMC, SIFMA, Financial Services Institute, Reich & Tang, Ropes & Gray LLP, Waddell & Reed; Americans for Financial Reform, iMoneyNet, Committee on Capital Markets Regulation, Squam Lake, SunTrust, Cumberland Valley, Chemung Canal, Virginia Treasurer, Harford County Treasurer, HBS, Davenport & Company, Capital Advisors Group, Sungard, Fein, Chapin Davis, Schapiro, Keener, Novelis, Karry.

<sup>17</sup> Release at 36581 (“We recognize that a floating NAV may not eliminate investors’ incentives to redeem fund shares, particularly when financial markets are under stress and investors are engaging in flights to quality, liquidity, or transparency.”); FSOC Proposed Recommendations at 69467(A floating NAV “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.”). In a recent report by the Treasury

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in detail, citing reports, comments and data filed with the Commission and the Financial Stability Oversight Council (“FSOC”) in earlier proceedings.<sup>18</sup> Comments on this issue in the current rulemaking file include the following:

- **National League of Cities:** “We understand the underlying theory to be that a floating NAV for prime money market funds would provide greater transparency into the underlying market value of a fund and therefore prevent runs if there was fear of it ‘breaking-the-buck.’ However, there is no empirical evidence showing that a floating NAV would serve this purpose.”
- **Virginia Treasurer:** “Perhaps this proposal is based on an assumption that if investors have knowledge of pricing it will discourage heavy redemptions as they seek to avoid the capital losses incurred by share withdrawals during such periods. Experience in other markets, notably the steep fall of the U.S. equity markets in 2008-09 and the European MMFs in 2008, where investors panicked despite daily pricing, suggests to us that daily pricing will not stop investors from demanding withdrawals during a financial system crisis.”
- **U.S. Bancorp:** “We believe floating the NAV completely fails to address MMF run risk. . . . Any deviation to the downside may cause investors to sell because of the potential for the NAV to be even lower the next day. Any deviation to the upside may cause speculative investors to take their gains.”
- **Independent Directors Council:** “[T]he floating NAV option is unlikely to prevent investors from redeeming fund shares in times of fund and market stress. . . . Thus, we

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Department’s Office of Financial Research at the request of the Financial Stability Oversight Council, Treasury analyzed *variable* NAV mutual funds as being subject to first mover advantage, fundamentally undercutting the premise that runs are caused by stable NAV share prices and can be addressed by forcing MMFs to move to a variable NAV. Office of Financial Research, Asset Management and Financial Stability 12-16 (Sept. 2013), <http://www.treasury.gov/initiatives/ofr/research/Pages/AssetManagementFinancialStability.aspx>. Indeed, in the designation of Prudential Financial, Inc. as systemically important, FSOC claimed a potential for “run risk” existed even in an entity with significant capital, a primarily retail investor base, and complete lack of historical evidence of runs.

<sup>18</sup> Letter from Arnold & Porter LLP to SEC 5-8 (Sept. 13, 2013) (titled “Problems with the Floating NAV”).

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question pursuing this option, which does not directly address the primary concerns of the Commission and whose impact on investors and the capital markets would be so burdensome.”

- **Invesco:** “[T]he most significant infirmity of the floating NAV proposal [is that] it fails to address . . . the risk of investor runs that could ultimately lead to systemic instability.”
- **HSBC** (reporting on its study of VNAV funds in France during the financial crisis): “[W]e cannot find any evidence for the argument that there are substantial differences between CNAV and VNAV funds, which cause CNAV funds to be more prone to run risk than VNAV funds.”
- **Dreyfus:** “The VNAV structure will diminish MMF utility substantially, without solving for redemption sensitivity in times of market crisis or improving the ability of investors to understand the risks associated with their MMF investment. The VNAV structure fails to adequately address the perceived ‘first mover advantage’ and should not be expected to reduce portfolio or systemic stress during times of market crisis.”
- **Fidelity:** “The floating NAV proposal does not provide an effective means to achieve the Commission’s stated goals because not only does it fail to prevent massive redemptions from institutional prime MMFs during times of market turmoil, but the extent of the structural changes actually could cause significant redemptions from MMFs, disrupt the financial marketplace, and increase systemic risk by increasing concentration of short-term assets in the banking system.”
- **UBS:** “In our experience, we have found that floating NAV short-term funds managed by UBS Global Asset Management were not less susceptible to redemption pressures than stable NAV money funds.”
- **Wells Fargo:** “[R]ecent practical experience in the form of significant redemptions from European variable NAV money market funds and U.S. ultra-short bond funds during the financial crisis of 2008 showed that a variable NAV likely does not prevent runs.”
- **Blackrock:** “We don’t believe that an FNAV MMF would decrease the incentive for investors to redeem shares in times of stress, nor do we believe that the additional transparency, if any, that a floating NAV would provide, would prevent runs.”

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- **PFM Group:** the FNAV would not “effectively diminish[] the potential for a ‘run on the fund’ by investors.”
- **State Street:** “SSGA does not believe that the adoption of a floating NAV would be an effective tool in preventing a run on a money market fund in times of financial stress.”
- **ICI:** “Even assuming that investors are willing to use floating NAV money market funds, a floating NAV is unlikely to alter meaningfully investors’ behavior during a market crisis. On the contrary, there is considerable evidence, as the SEC itself acknowledges, that the outflows from prime money market funds during September 2008 were part and parcel of a flight by investors to the quality and liquidity of the Treasury market. Indeed, there is evidence, as the SEC also acknowledges, that long-term funds (whose NAVs have always floated) experienced significant outflows during the financial crisis.”
- **George Mason Mercatus Center:** “[E]vidence suggests that investors run from funds that have taken on riskier assets or lack liquidity to meet redemptions. Even with a floating NAV, investors would have an incentive to run early from funds that they anticipated would later experience problems.”
- **SIFMA:** “Many of our members believe that the floating NAV will be ineffective to reduce the susceptibility of money market funds to destabilizing runs . . . .”
- **American Bar Association:** “[T]he extent to which a money market fund's floating NAV would reduce incentives to redeem may be marginal and, in any event, highly contingent on the type of ‘stress’ experienced by a particular money market fund or the debt market in general.”
- **Association for Financial Professionals:** “[W]e maintain that implementing a floating NAV does not address potential fund runs, nor does it preserve the benefits of MMFs for investors and short-term financing markets. Rather, a floating NAV can adversely impact the investment incentive for MMFs and effectively destabilize market demand for these funds regardless of prevailing economic conditions. Considering the consequences a floating NAV might have on short-term debt markets for corporates and municipalities, we urge the SEC to consider the ramifications of reduced investor interest in prime institutional MMFs.”

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- **Financial Services Roundtable:** “Some FSR members also are concerned that a floating NAV may not move the MMMF industry toward the Commission’s goal of reducing the incentive to redeem shares in times of financial stress. In fact, a floating NAV may exacerbate such an incentive.”

This is not to suggest that there is unanimity on this point.<sup>19</sup> Some commenters speculate that a floating NAV would mitigate systemic risk generally or the risk of “runs” on MMFs in particular. But, even supporters have failed to produce data to support the theoretical proposition that a floating NAV would mitigate run risk.

## 2. Impact of a Floating NAV in Changing Investor Perceptions of MMF risk

Federated and other commenters also reject the Commission’s theory that requiring investors to purchase and redeem MMF shares at a floating NAV will change investor expectations of MMF risk, make investors more accustomed to NAV fluctuations and, thus, make investors less likely to redeem in times of stress.<sup>20</sup> Indeed, the majority of commenters who addressed this issue agreed that requiring investors to purchase and redeem MMF shares at

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<sup>19</sup> Vanguard (“We note that those who oppose the floating NAV will argue it will not prevent investors from redeeming their MMF shares. We agree. Even bond funds, which have fluctuating NAVs, can and do experience heavy redemptions. The reason the floating NAV would mitigate the risk of disruptive shareholder redemptions in institutional prime MMFs is that the process of moving from a stable NAV to a floating NAV will force [institutional] shareholders . . . into different investment vehicles.”), T. Rowe Price (“Although we are aware of no direct evidence that a floating NAV will meet the SEC’s goal of preventing a run on money market funds . . . we believe that if the SEC adopts a floating NAV requirement for institutional prime money market funds . . . the potential systemic risk would be significantly reduced if not eliminated.”), Northern Trust (“We agree with the Commission that moving to a floating NAV will likely reduce the ‘run’ risk but will not eliminate it.”). *See also* Thrivent, Deutsche, Schwab. The Systemic Risk Council also observed, “If a fund’s assets are worth less than a \$1.00 – and you can redeem at \$1.00 – the remaining shareholders are *effectively paying* first movers to run, which embeds *permanent losses in the fund for the remaining holders*.” Of course, there can be no advantage to early redeemers if MMF directors have the tools, and appropriately exercise them, to “stop a run in its tracks” through a temporary suspension of redemptions, a tool that would be available under Alternative Two and, indeed, would be far more effective in protecting shareholders from unfair result or material dilution. We discuss the comments on Alternative Two below.

<sup>20</sup> *See* Letter from Arnold & Porter LLP to SEC 9-11, 24 (Sept. 13, 2013) (titled “Problems with a Floating NAV”). *See also* National League of Cities, American Bar Association, ICI, Financial Services Institute, Sungard, Silicon Valley Bank, Chapin Davis, Barnard, Edwardsville, Hepburn, Dreyfus, Wells Fargo.

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a fluctuating NAV is a wholly unnecessary and extremely costly and disruptive means to communicate what investors already know – that the value of MMF shares can fluctuate and that MMF shares carry risk. Commenters emphasized that observing insignificant fluctuations in value would not affect investor behavior in times of stress and that disclosure and investor education are much more efficient means to inform investors of MMF risks. The following are some representative comments on this issue:

- **Oppenheimer:** “[D]isclosure and investor education initiatives are preferable means of creating investor awareness, without the market disruption and additional costs and burdens that a floating NAV will produce.”
- **ICI:** “[A floating NAV is] an inefficient way to educate investors that money market funds may lose value—it is extremely costly to fund complexes, to intermediaries, to investors, and to the economy as a whole. Effective disclosure of funds’ portfolio holdings and other key characteristics, combined with daily disclosure of funds’ mark-to-market share prices accomplish the same goal, without the potential for troubling disruptions to our economy and fundamentally altering the key features that investors value most.”
- **Sungard:** “In view of the very extensive and prominent prospectus disclosures of the risk that a MMF can ‘break a buck’ (not to mention the extensive discussion of the issue in the press and regulatory commentary), the many surveys and testimony documenting that investors understand this risk, and the fact that institutional investors clearly can grasp this issue, the second stated purpose behind Alternative 1 does not warrant the tremendous costs and disruption that the VNAV proposal would bring about.”
- **Silicon Valley Bank:** “The notion that a floating NAV ends a false perception of stability in the marketplace ignores the fact that investors are already aware of the risk nature of these vehicles. Every fund marketing document and prospectus is required to state that the fund ‘may lose value.’ Furthermore, our clients are well aware of the problems the MMF industry went through in 2008. We communicated openly and often about what was happening during that time. Nonetheless, our clients continue to use MMFs and mitigate their risk through due diligence and monitoring of existing disclosure requirements.”



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- **George Mason Mercatus Center:** “It is unclear how shifting institutional funds to a floating NAV and making related disclosure changes will assist retail investors in better understanding the risks of MMFs.”
- **American Bar Association:** “[I]t does not seem at all clear . . . that a floating NAV based on pricing models incorporating assumptions about value rather than based on market prices will accomplish much, if anything, to ameliorate conditions of ‘imperfect transparency.’”
- **Independent Directors Council:** “[W]hile the Commission states that the floating NAV proposal is designed to increase the transparency of money market fund risk, there are other, less burdensome ways to do so, such as monthly disclosure of funds’ portfolio holdings and daily disclosure of funds’ market-to-market share prices . . . .”
- **J.P. Morgan:** “Disclosure, including current market-based NAVs, provides the same level of transparency regarding MMFs to investors that would be provided by a floating NAV.”
- **Committee on Capital Markets Regulation:** “Requiring . . . funds to convert to a floating NAV may be unnecessary to accomplish this goal, as numerous money market funds—including those sponsored by BlackRock, Charles Schwab, Federated Investors, Fidelity Investments, Goldman Sachs, J.P. Morgan, State Street Global Advisors, and Wells Fargo—already disclose their shadow NAV on a daily basis.”
- **Wells Fargo:** “The Release . . . argues that a stable NAV obscures the risks of money market funds by failing to expose investors to the fact that the market value of shares may fluctuate . . . . We note that this rationale conflicts somewhat with the Release’s hypothesis that runs on money market fund occur because certain investors acutely understand that the market value of shares may deviate materially from \$1.00 . . . .”

Recent studies and surveys submitted to the Commission underscore and supplement prior submissions on this point, including a comment letter from academics at Texas Tech, which finds that investors do not derive additional transparency value from a floating NAV where the



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fund's portfolio instruments trade only infrequently, and that a floating NAV becomes even less informative during a crisis.<sup>21</sup> That study stated the following:

- **Texas Tech:** “While one may expect floating NAV to be more informative than a fixed NAV, this assumes the existence of transaction prices for the securities in the fund’s portfolio. Accordingly, floating NAV should be relatively informative when the securities in the fund’s portfolio trade frequently. Conversely, as the securities in the fund’s portfolio trade less frequently, the fund is forced to rely on price estimates. A fund’s reliance on estimated prices potentially decreases the information provided by a floating NAV. This issue is particularly acute for MMFs as most money market securities do not trade, and instead, are typically bought and then held to maturity. Therefore, the informativeness of floating NAV for MMF investors is an open question.”

A small number of commenters stated that a floating NAV would provide additional transparency to MMFs.<sup>22</sup>

**B. Commenters overwhelming warned that the floating NAV will impose operational, tax, accounting, and legal burdens on users and will introduce additional and unnecessary pricing complexity.**

**1. Commenters’ Concerns About Operational and Other Burdens of a Floating NAV**

In a letter filed September 13, 2013, on behalf of Federated, we explained that requiring MMFs to adopt a floating NAV would destroy features that make MMFs an attractive cash management option for investors.<sup>23</sup> The letter also included a detailed appendix discussing a

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<sup>21</sup> Indeed, these recent studies merely confirm an extensive survey of mutual fund investors conducted by regulators in the mid-1990s, which found that even prior to the Reserve Fund breaking a buck in 2008 and prior to the enhanced disclosure requirements under the 2010 amendments to Rule 2a-7, 63.9% of investors understood that it is possible to lose money in a MMF. Gordon J. Alexander, et al., Mutual Fund Shareholders: Characteristics, Investor Knowledge, and Sources of Information, Office of the Comptroller of the Currency Working Paper 97-13 at 11 (1997), <http://www.occ.gov/publications/publications-by-type/occ-working-papers/1999-1993/wp97-13.pdf>.

<sup>22</sup> See Federal Reserve Banks, Capital Advisors Group, Wisconsin Bankers Association.

<sup>23</sup> See Letter from Arnold & Porter LLP to SEC 24-31, 35-43 (September 13, 2013) (titled “Problems with the Floating NAV”).

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range of MMF uses that could not be effectively continued with floating NAV MMFs. The letter detailed:

- The systems and operational challenges for intermediaries, users, transfer agents, and fund sponsors in implementing a floating NAV;
- The substantial daily operational, tax, accounting, and recordkeeping burdens associated with a fluctuating fund; and
- The extent to which certain investors, both institutional and public sector, would not be able to invest in floating NAV MMFs due to statutory restrictions or investment guidelines requiring stable value investments.

The vast majority of commenters who addressed the use of MMFs as a cash management tool agreed that a floating NAV MMF would destroy the utility of MMFs for this purpose.<sup>24</sup> According to commenters, imposing a floating NAV requirement on a large subset of MMFs would destroy key operational features that make MMFs useful to investors and would require costly retooling by investors and intermediaries.<sup>25</sup> MMF systems providers in particular described in detail the complex software and other systems upgrades that would be required to accommodate a floating NAV and basis point rounding.<sup>26</sup> As **Silicon Valley Bank** noted, these

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<sup>24</sup> Letter from 42 Members of Congress, Government Finance Officers Association, St. Louis Treasurer, National League of Cities, National Association of College and University Business Officers, NASACT, Georgia, California, Metropolitan Mayors Caucus and Signatories, Government Investment Officers Association and State Treasurer Signatories, Massachusetts Association, Rhode Island Treasurer, North Carolina Metropolitan Mayors, Angel Research Paper, Keener, Hepburn, Karry, Greater Durham Chamber, Smithville, Schapiro, Novelis, Harford County Treasurer, Pima County, Green, Silicon Valley Bank, Financial Services Institute, Sungard, Edwardsville. We are aware of only one commenter, Thrivent, that suggested floating NAV funds would still be useful for cash management purposes, although this commenter did not suggest solutions to the myriad operational, tax, or administrative challenges raised by other commenters.

<sup>25</sup> Chamber-CCMC/TSI, SIFMA, Chemung Canal, DST, Virginia Treasurer, Government Finance Officers Association, Rhode Island Treasurer, St. Louis Treasurer, National League of Cities, NASACT, R.I. Governor Lincoln Chafee, Florida CFO, Government Investment Officers Association and State Treasurer Signatories, Massachusetts Municipal Association, New Hampshire, Kentucky Treasurer, American Benefits Council, Chamber-CCMC, Angel Research Paper, ICI, American Bankers Association, DCIIA, Financial Services Roundtable, Association for Financial Professionals, Wells Fargo, Committee on Capital Markets Regulation, Santoro, Boeing, State Treasurer of Massachusetts, Harford County, West Virginia BIT, NASACT, Edwardsville, M&T Bank, Cumberland Valley, Mainsource, Woodlands Bank.

<sup>26</sup> DST, State Street, Interactive Data, Sungard. *See also* Chamber-CCMC/TSI, M&T Bank.

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upgrades will be necessary to process transactions at a floating NAV “while providing no increase in investor protection.”<sup>27</sup> In addition to these operational challenges, commenters also warned of the tax and administrative burden of tracking minute increases or decreases in share prices each time MMF shares are bought or sold.<sup>28</sup> The consensus of these commenters is clear: whether or not systems *could* be retooled or the tax and administrative burdens of floating NAV MMFs reduced, many investors would seek out alternative investment products rather than incur the resulting costs.<sup>29</sup> In addition to the operational burdens that would drive investors away from MMFs, many institutional and public sector commenters explained that legal or investment restrictions would prevent them from investing in floating NAV MMFs.<sup>30</sup> Representative comments include the following:

- **R.I. Governor Lincoln Chafee:** “A floating NAV may increase transaction costs, require costly system changes, and increase the workload of handling daily investments. State and local governments are already doing more with less resources and staff. This would add another unnecessary burden to the cost of running government.”
- **Boeing:** “We believe eliminating this key feature of MMFs – a stable NAV – will result in the loss of MMFs as a useful liquidity and principal preservation tool for

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<sup>27</sup> Silicon Valley Bank.

<sup>28</sup> TexSTAR, Government Investment Officers Association and State Treasurer Signatories, American Benefits Council, SIFMA, Chamber-CCMC, Angel Research Paper, ICI, American Bankers Association, Financial Services Roundtable, TSI, Dreyfus, Committee on Capital Markets Regulation, Adamson, Lupinacci, TexSTAR, National League of Cities, NASACT, Florida CFO, Square 1, Silicon Valley Bank, Futures Industry Association, SunTrust. Only one commenter, the Federal Reserve Banks, thought the proposed relief offered by the Internal Revenue Service would substantially minimize the tax consequences of the floating NAV. Indeed, some commentators wrote that they could support a floating NAV only if financial reporting, accounting, and tax concerns were fully addressed before implementation. *See* Goldman, Northern Trust. Schwab argued that the tax treatment and reporting issues relating to a floating NAV must be resolved before the rule takes effect.

<sup>29</sup> *See, e.g.*, NASACT, Pima County, SIFMA, Chamber-CCMC, Angel Research Paper, ICI, American Bankers Association, TSI, Silicon Valley Bank, M&T Bank, Edwardsville, Chemung Canal.

<sup>30</sup> 42 Members of Congress, Angel Research Paper, Chicago Treasurer, Government Finance Officers Association, TexSTAR, Governor Deval Patrick, San Diego, Government Finance Officers Association and Public Sector Signatories, National Association of College and University Business Officers, NASACT, California Association of County Treasurers and Tax Collectors, Metropolitan Mayors Caucus and Signatories, American Benefits Council, Chamber-CCMC, Treasury Strategies, American Bankers Association, TSI, Woodlands Bank, MainSource, United Bank, New Jersey Chamber, Cleco Corporation, Shapiro.

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corporations. . . . Given our daily cash movements, our utilization of banks is somewhat limited with respect to such short term withdrawal or investment of cash in a 24-hour period. Importantly, it is a common occurrence for our banks to actively discourage such short term deposits and offer a rate of return close to zero in an effort to dissuade such investments. Therefore, the use of MMFs—with their flexibility—is imperative to our daily business.”

- **Cleco Corporation:** “The precision and sophistication with which we currently manage our liquidity position to maximize returns will be fractured, and the introduction of a net asset value per share computed on a mark-to-market basis (causing our cash position to fluctuate in value) will not coincide with our existing policies or systems capacities with respect to liquidity management.”
- **St. Louis Treasurer:** “[T]he requirement that prime institutional money market funds operate with a floating net asset value will require that the City of St. Louis and other municipalities to either make expensive changes in accounting systems and reporting protocols or seek alternative investments that may have more risk and lower yields.”
- **West Virginia Board of Treasury Investments:** “There could also potentially be significant costs incurred in updating the State’s accounting systems to handle a floating NAV. The State’s participant accounting system is designed to operate on a share basis. To process transactions using a variable NAV, the State would be required to upgrade or replace its existing system, incurring what would otherwise be unnecessary expenses during tight budgetary times.”
- **Government Finance Officers Association:** “Many governments invest in money market funds because of their secure nature, simple accounting methodology and management, and liquidity – all features that are necessary for governments to protect public funds, access cash and pay bills when they are due. Changing the main feature of these funds to a floating NAV would create administrative and costly burdens to governments, large and small.”
- **Farmers Trust Company:** “[M]any of our operational procedures related to recordkeeping, systems, administration and reporting have been ‘hard wired’ into our service model at considerable cost. Structural changes to institutional prime funds, particularly the proposal by the SEC that such funds value their shares using a variable

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net asset value, may result in serious disruptions to our retirement business and, in our view, create substantial confusion and concern for the plan participants.”

- **State Street:** “In the absence of extremely costly (probably cost-prohibitive) system enhancements, we are concerned that adoption of this Alternative will significantly limit the utility of money market mutual funds as short-term investment vehicles for a broad range of institutional investors.”<sup>31</sup>
- **iMoneyNet:** “Based on feedback we have received from both fund sponsors and investors, the elimination of the stable share price could result in an 80–90% reduction in institutional prime fund assets, if not the total elimination of this very valuable cash-management tool. This scenario would have a major negative impact, not only on money fund sponsors, but also the commercial paper markets and the greater economy.”
- **ICI:** “[T]he floating NAV proposal would require funds and intermediaries to make very significant and costly operational changes to accommodate floating NAV money market funds. Regulators might argue that such costs are justified by the policy concerns at stake. The argument misses the point, however; the operational changes required are so extensive, difficult, and costly that sponsors and intermediaries are unlikely to make the substantial investment required, unless they believe investors would accept a floating NAV product in meaningful numbers. . . . The lukewarm policy goals set out in the proposal do not appear to justify these costs.”
- **Association for Financial Professionals:** “[W]e are concerned about the feasibility of offering same-day liquidity on shares of prime institutional MMFs that are exposed to fluctuating valuation throughout the day, with the redemption price determined only at end-of-day. Delivering funds only after end-of-day pricing eliminates the immediate liquidity effectively offered by stable NAV MMFs and required for working capital management.”
- **United Bank:** “In virtually all circumstances, our clients’ assets require a precise valuation (sometimes by state statute, governing documents or client investment

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<sup>31</sup> See also Sungard (“The accounting and recordkeeping systems that we use to process these transfers and payments are highly automated, and link together with automated systems of banks and the MMFs’ transfer agents. It would be very expensive (and potentially not economically viable) to rebuild our automated systems to process these transfers and payments at other than \$1/share.”).

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limitations) to ensure seamless and predictable liquidity services. The introduction of a variable net asset value would, in essence, result in what has become a cost effective and highly efficient service reverting to a pre-money market mutual fund business model that existed in the early 1970s.”

- **Dreyfus:** A floating NAV MMF “will not be a meaningful part of the cash management marketplace because FNAV MMFs cannot offer same-day liquidity.”
- **Oppenheimer:** “[A] floating NAV will create significant operational and systems difficulties and added costs that shareholders ultimately will bear.”
- **Invesco:** A floating NAV “would reduce significantly the utility of the affected MMFs for the majority of their investors [and] would trigger a wide variety of unintended and undesirable consequences. . . . The requirement for institutional prime funds to adopt floating NAVs would raise a variety of significant operational challenges due in large part to the interdependencies of the various users of MMFs.”<sup>32</sup>
- **U.S. Chamber and Business Joint Letter:** “Much attention has been focused on the complicated tax and accounting issues that need to be resolved in order to impose a floating NAV, and we do not want to diminish their importance. Nevertheless, regardless of the resolution of these issues, the simple fact is that most businesses will not invest their cash in a floating NAV MMMF. The modest returns from these investments will not justify the commitment of time and resources needed to manage an investment program in MMMFs that have a floating NAV.”
- **Government Finance Officers Association and Public Sector Signatories:** “[M]any, if not all, of [our] members would divest a significant percentage of their MMMFs and would have to look at competing products that in turn could be a riskier investment for public funds, more susceptible to market conditions, more difficult to account for and manage, and would have a lower rate of return.”

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<sup>32</sup> Some letters from the fund industry underscored the significant operational implications and costs of moving to a floating NAV. *See, e.g.*, letters from Fidelity, J.P. Morgan and Federated.

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- **National Association of College and University Business Officers:** “Many nonprofit institutions are required, by law or by investment policy, to invest cash only in products offering a stable value.”
- **Fein:** “The floating NAV requirement in particular would necessitate costly operational changes for MMFs and their institutional shareholders, many of whom have indicated they would discontinue using MMFs.”
- **George Mason Mercatus Center:** “The floating NAV option would fall far short of the SEC’s goal of ‘preserving, as much as possible, the benefits of money market funds.’ It would impair the day-to-day utility of MMFs for many investors. It would require substantial operational and technology changes. It would require substantial operational and technology changes. It would eliminate the tax, accounting, recordkeeping and operational benefits provided by stable NAV funds.”
- **Angel Research Paper:** “The lack of a stable NAV will reduce the ability of funds to provide intraday redemptions, impairing the liquidity which is one of the core value propositions of MMMFs. It is clear that eliminating the most basic attribute of the product, its stable value, will cause investors to shift to other products.”
- **American Bankers Association:** “[W]e believe prime MMFs with FNAV would very likely cease [to] be a viable product for our members when investing on behalf of their fiduciary accounts and providing other consumer products, such as sweep accounts.”

Given these consequences of the floating NAV, it is not surprising that 1,381 of the 1,431 commenters – over 96% – oppose or raise substantial questions regarding the Commission’s floating NAV proposal.<sup>33</sup>

## **2. Commenter Concerns About the Elimination of the Amortized Cost Method**

Letters filed on behalf of Federated September 13 and 16, 2013 provide extensive commentary and data on the impact of the Commission’s proposals to alter the way MMFs are priced for purchases and redemptions – proposals to eliminate the amortized cost method of

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<sup>33</sup> Thirty of the 1,431 comment letters did not address Alternative One or otherwise could not be categorized.



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valuation and to require MMFs to use “market-based” valuations at variations of 1/100<sup>th</sup> of a cent.<sup>34</sup> In brief:

- Requiring “market-based” pricing for floating NAV funds and requiring stable value funds to penny round from “market-based” valuations will push back settlement times by hours, or even overnight, increasing costs, burdens, and risks, including risks in payment systems and markets;
- Because most prime MMF portfolio instruments are not actively traded, the time-consuming and costly processes to derive “market-based” valuations will not produce “mark-to-market” prices but only “good faith opinions” – as pricing vendors themselves characterize their valuations;
- The proposals will result in undue reliance on pricing vendors and a risk of errors and breakdowns;
- Requiring pricing to the fourth decimal point suggests a level of accuracy that itself is misleading to investors; and
- Because the current amortized cost method of valuing MMF shares can only be used if it fairly reflects the “market-based” NAV, the Commission’s proposal to change the way MMFs are priced for purchases and redemption will provide no benefits whatsoever to investors – particularly where “market-based” valuations are disclosed to investors as a benchmark.

A number of other commenters addressed why the amortized cost valuation method is more appropriate for MMFs and better for investors than the matrix- or model-based valuation upon which floating NAV pricing would be based.<sup>35</sup> The following are representative comments on this issue:

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<sup>34</sup> See Letter from Arnold & Porter LLP to SEC17-24, 31-35, & App’x One, (Sept. 13, 2013) (titled “Problems with the Floating NAV” and providing a detailed timeline of the process for striking a daily NAV for a typical prime fund). See also Arnold & Porter LLP to SEC (Sept. 14, 2013) (titled “Elimination of the use of the Amortized Cost Method of Valuation by Stable Value Money Market Funds”).

<sup>35</sup> See, e.g., Stradley Ronon (“Consider that the prices of many money market fund securities are evaluated prices calculated by pricing services, rather than market values. . . . Accordingly, the minute fluctuations are less likely in money market funds than in other funds to represent an actual change in market value. Accordingly, treating money

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- **U.S. Bancorp:** “No longer allowing a fund to value securities at amortized cost means shareholders could potentially be exposed to an incorrect NAV while a price is being challenged or ushered through the fair-value procedures. We believe inaccurate prices could be the cause of shareholders transacting at incorrect NAVs, the threat of which opens up a whole new set of risks.”<sup>36</sup>
- **Legg Mason:** “The amortized cost method determines valuations based on actual costs and actual accruals of discounts and premiums and thus provides a fair degree of precision in valuation. This precision is not available without the use of amortized cost. . . . Fair value pricing, with its attendant judgments, would appear to frustrate the Commission’s stated goal of price transparency. The same security, held by two different funds with different pricing vendors, could show different valuations. . . . Investors that purchase shares based on interim fluctuations could either be diluted or benefitted, which is a potentially unfair result. The amortized cost method provides less possibility for this unfair dilution.”
- **Goldman:** “A price derived based upon a discounted value methodology . . . will depend upon the model, interest rate and various assumptions. A price based on a matrix will depend upon the construction of the matrix and the securities included. As a result, it is not unusual for pricing services to provide different marks within a range, and for different fund boards to adopt different policies (such as averaging) to reconcile them. It is not at all clear to us that converting these estimates to prices calculated to the fourth decimal place . . . will contribute to greater transparency. At that level, we believe that price distinctions among money funds could turn substantially more on the valuation models used rather than the intrinsic value of the securities, let alone the price at which a security could be sold. We caution the Commission against seeking additional price

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market funds differently from other floating NAV mutual funds in this regard may be an ineffective means to provide meaningful information to shareholders or to discourage rapid redemptions.”). *See also*, ICI, SIFMA, Chamber-CCMC, Angel Research Paper, Financial Services Institute, Virginia Treasurer, Georgia, Texas Tech, Legg Mason, Invesco, Waddell & Reed.

<sup>36</sup> U.S. Bancorp’s letter also observed, “Historically, in times of compromised liquidity or market stress, secondary market trading of securities has been reduced making market prices more difficult to obtain. Failure to price securities in a fund could lead a fund to delay its NAV determination, directly impacting shareholder ability to trade fund shares at a time when liquidity is most prized.”

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precision simply to demonstrate risk to investors without giving careful consideration to the validity of the resulting prices.”

- **Institutional Cash Distributors:**<sup>37</sup> “Those who criticize the amortized cost methodology of calculating MMF NAVs as insufficiently precise need to understand that the proposed alternative ‘mark-to-market’ accounting is likewise imprecise, given the lack of real-time asset prices for many of the portfolio assets. In light of MMFs practice of holding short-term assets to maturity, the amortization method produces the appropriate valuation. Moreover, amortized cost is the normal form of accounting for assets that the holder does not intend to sell and will hold back to maturity.”

Many commenters strongly oppose the proposed requirement for “basis point” pricing, arguing that it would be cost prohibitive, operationally difficult for systems to accommodate, and misleading to investors.<sup>38</sup> Comments on this element of the proposal include the following:

- **Dreyfus:** “We think this intentional effort to overstate MMF price fluctuations . . . is inappropriate and should not be undertaken by the Commission. It has no place in making the risk of CNAV MMFs more transparent.”
- **Fidelity:** “[W]e believe that this increased precision greatly exaggerates the risks of investing in a MMF as compared to other types of floating NAV mutual funds.”
- **Invesco:** “The impact of a requirement to trade and transact at four decimal places cannot be underestimated. . . . We believe these costly and unnecessary changes are unjustified . . . .”
- **Schwab:** “Building the capacity to *transact* at a fourth decimal place would require a costly restructuring of the system. . . . [W]e do not see that this cost would produce any real benefit to investors. . . . Any fund that prices to four decimal places will show more ‘volatility’ than one that prices to two or three decimal places. But this volatility is artificial and misleading. . . . We believe that basis point rounding will lead investors to think that a basis point change in the price of a money market fund is a meaningful

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<sup>37</sup> Citing Professor Jonathan Macey.

<sup>38</sup> See, e.g. ICI, SIFMA, Suntrust, Stradley Ronon, DST, Government Investment Officers Association and State Treasurer Signatories, Angel Research Paper, SunTrust.

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change in the value of their shares. . . . But requiring transactions and pricing at that level of detail strikes us as unreasonable.”

- **Blackrock:** “If MMFs are required to use basis point rounding, we believe investors will be incentivized to invest in ultra-short bond funds with investment parameters similar to money market funds which could still use ten basis point rounding in which to transact shares.”
- **Stradley Ronon:** “Basis point rounding may be misleading to shareholders, without providing meaningful information. Consider a shareholder who owns shares of both a floating NAV money market fund that uses basis point rounding and shares of a short term bond fund that rounds NAV to the tenth of a penny, and that hold similar securities. The share value of the floating NAV money market fund may fluctuate on more days within a given period than the share value of the short-term bond fund, due to the different rounding conventions, with no meaning attached to the more frequent fluctuation.”

In addition to the impact on investors and the costs of implementation, commenters wrote that the proposed elimination of the amortized cost method would cause substantial delays in transactions and would threaten or preclude the ability of MMFs to continue to offer same-day settlement capabilities upon which shareholders rely, or would require MMFs to move their time of day for pricing earlier in the day.<sup>39</sup> This would occur not only for floating NAV MMFs but for CNAV funds required to penny round from market-based valuations. Commenters also warned that the floating NAV would create settlement bottlenecks and delays for investors and intermediaries, introduce new risks from potential technology breakdowns and systems failures at pricing vendors, and potentially impose systemic risks on payment systems and markets.<sup>40</sup>

- **SIFMA:** “[A]n early closing time will not adequately accommodate client needs and will have negative repercussions in the capital markets . . . .” SIFMA’s survey of its members found that 61% of distributor/intermediaries did not expect to support same-day settlement if amortized cost valuation was eliminated.

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<sup>39</sup> See U.S. Chamber Joint Letter, Square 1, Silicon Valley Bank, Smithville, Kentucky Chamber, Financial Information Forum, Edwardsville, Cumberland Valley, Chemung Canal, West Virginia, KeyBank, SIFMA, ICI, Invesco, Dreyfus, U.S. Bancorp, Sungard.

<sup>40</sup> Chapin Davis, DST, Angel Research Paper.

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- **ICI:** “[U]nder penny rounding alone, money market funds that now offer same-day settlement several times a day, and wished to continue doing so, would need to obtain intraday price quotes from vendors. These funds also would need to make significant systems modifications and procedural changes to support a multiple, intraday NAV calculation process for their stable NAV funds. Both the availability of data from pricing vendors and costs associated with striking an NAV multiple times a day may force funds to dramatically change the current liquidity available to investors through same-day settlement.”
- **Sungard:** “The Commission’s Release . . . makes the assumption that, if shares are rounded to the nearest penny, there is no need to use amortized cost accounting. This is not a correct assumption. If CNAV share prices are valued using mark-to-market or mark-to-model portfolio prices with share prices rounded to nearest cent, the price of the portfolio changes very slightly throughout the day, requiring constant coordination by the MMF and updating share prices with market or model price information generated after the purchase order is received, which is then rounded to the nearest cent. This introduces a time delay between the receipt of the MMF share purchase or redemption order, the processing of that order (so that prices can be recalculated) and the subsequent settlement of that order. It also introduces additional processing costs for the calculating and striking of that share price – even though the price is still rounded to the nearest penny. Together, the increased cost of pricing and the delay in pricing will lengthen processing and settlement times and makes it difficult to coordinate MMF share purchases and redemptions with the related cash transactions. The elimination of amortized cost accounting at government funds and retail funds that are permitted to use a stable net asset value will make late-day settlements more difficult, and reduce the number of times during the day that intra-day settlements can be conducted.”
- **DST:** “Floating NAV reform, as written, would triple the level of daily servicing effort and roughly triple the processing risk by introducing complexities and reconciliation requirements.”

Few commenters who support the floating NAV proposal provided specific commentary on the reliability of “market-based” pricing or the need for pricing at variations of 1/100<sup>th</sup> of a penny. Comments on this subject by the **Systemic Risk Council**, which urged the Commission to require a floating NAV for all MMFs, demonstrate a lack of understanding of the characteristics of MMF portfolio holdings by referring repeatedly to “mark-to-market” pricing of

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the portfolios – which the Commission itself acknowledges does not exist for the “vast majority” of prime MMF portfolio instruments.<sup>41</sup> Most curious is the comment letter from the **Federal Reserve Banks**, which observes that the “effectiveness of a floating NAV option depends on funds’ ability to properly value money market instruments” – while conceding that the lack of market prices necessitates the use of matrix pricing and model-based valuations to arrive at a floating NAV.<sup>42</sup>

### 3. Commenter Concerns About Alternative One’s Exemptions for Retail and Government MMFs

In a letter filed September 13, 2013 on behalf of Federated, we explained that the Commission’s proposed exemptions for “retail” and “government” MMFs would not alleviate the burdens of the floating NAV proposal but instead will add significant complexities and operational burdens to MMF transactions and limit their appeal among many users.<sup>43</sup> In brief:

- The intricate systems to monitor and control the \$1 million daily redemption limit would be extremely difficult to develop, implement, and operate, particularly for MMFs that are not direct sellers to the end customer, and would lead to processing delays, additional costs, and reduced market efficiency;
- The \$1 million redemption limit will render MMFs unavailable to many investors, including retail investors and investors in tax exempt MMFs, engaging in transactions that are large but not driven by an effort to redeem ahead of declining share value;
- The elimination of amortized cost for retail and government MMFs will push back settlement times by hours or overnight, create settlement bottlenecks, and increase costs and risks while serving no regulatory purpose as shares will ultimately be rounded to the \$1.00 per share price; and

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<sup>41</sup> Release at 36837.

<sup>42</sup> The Federal Reserve Banks’ letter then encourages the Commission to move forward with efforts to enhance price discovery in the fixed income markets. The Federal Reserve Banks’ acknowledgement of the imprecision of “market-based” valuations, while at the same time urging the Commission to impose this imprecise method on MMF shareholders at enormous cost and disruption, is difficult to reconcile.

<sup>43</sup> See Letter from Arnold & Porter LLP to SEC (Sept. 13, 2013) (titled “Problems with Alternative One”).

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- By leaving government MMFs as the only viable stable value cash management vehicle for many investors, the Commission effectively is promoting the ability of the federal government to borrow at the expense of state and local governments and private issuers in a manner contrary to the Commission's obligation to consider the effects of its rules on competition, market efficiency, and capital formation.

The majority of commenters who addressed the issue confirmed that the proposed exemptions in Alternative One do not alleviate the disruptive effects of the proposal on individuals or users of tax exempt or government MMFs,<sup>44</sup> although some commenters voiced support for a regulatory distinction between retail and institutional investors.<sup>45</sup> Many commenters observed the difficulty of creating this distinction, however, and warned that the Commission's proposed retail exemption would not achieve its intended purpose.<sup>46</sup>

- **M&T Bank:** "The Wilmington MMFs, like most money market funds, offer different classes of shares, with different cost structures and other features, to different types of investors. Under the Commission's floating NAV proposal, the Prime and Tax-Exempt Wilmington MMFs would have to split into separate "retail" and "institutional" funds, transactions that would require shareholder votes. The time and expense of such an exercise would not prove valuable, as M&T is confident that current shareholders in the Prime and Tax-Exempt Wilmington MMFs who would be classified as "institutional" under the proposal would simply leave the funds because they have no interest in a floating NAV. 'Shorn' of their institutional shareholders, the retail-only funds would have lost significant scale and may become uneconomical to operate after 35 years of service to M&T's customers and clients."
- **Woodlands Bank:** "We are familiar with the distinction the SEC has drawn between 'retail' customers and 'institutional' customers in categorizing prime funds. Unfortunately, the methodology used by our department to create liquidity on a regular or

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<sup>44</sup> American Benefits Council, CMFI, SIFMA, ICI, American Bankers Association, DCIIA, Financial Services Roundtable, Mutual Fund Directors Forum, SPARK, Wells Fargo, M&T Bank, Woodlands Bank, Fidelity, Goldman, Reich & Tang.

<sup>45</sup> Angel Research Paper, Committee on Capital Markets Regulation, Robert Comment, TIAA-CREF, Edward Jones, Financial Services Institute.

<sup>46</sup> Invesco, Fidelity, Square 1. The Federal Reserve suggested that the tendency of retail investors not to redeem during periods of market stress in the past does not necessarily mean retail investors would not do so in the future.

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as-needed basis for our clients does not fit within the artificial distinction made in the release between institutional and retail customers.”

- **Invesco:** “[T]he proposed distinction between ‘retail’ and ‘institutional’ funds is artificial and difficult to implement.”
- **Fidelity:** “The proposed definition of a ‘retail’ fund does not achieve the SEC’s intended policy objectives . . . because a significant portion of what the MMF industry currently defines as retail assets would fall outside the definition.”<sup>47</sup>
- **Goldman:** “We strongly oppose different treatment of institutional and retail money funds. . . . [T]he SEC’s proposed distinction between “institutional” and “retail” funds is arbitrary and may encourage gaming and confusion in the marketplace.”

Commenters also explained in great detail that the exemptions would require costly retooling. Many intermediaries and others stated that the redemption limit would prevent the offering of retail funds in the omnibus context.<sup>48</sup>

- **SunTrust:** “Our Consultant estimates that manually examining and recoding our computer systems to identify and track the beneficial owner of each of our accounts and reconfiguring SunTrust’s computer systems to coordinate and track 2a-7 fund redemptions currently made thorough its three separate mutual fund sub-transfer agents will require SunTrust to spend tens of millions of dollars in initial startup costs and will thereafter increase its annual cost of operations by additional millions. Furthermore, neither SunTrust nor our Consultant is aware of any existing system whatsoever which can, in real time, coordinate and track redemption orders placed within SunTrust, with (i) other omnibus Intermediaries and (ii) directly with the mutual fund as required by Alternative 1’s Retail Fund Exemption. For the reasons set forth above, SunTrust believes that, in the case of omnibus accounts, compliance with the Retail Fund Exemption’s \$1,000,000 daily trading limit will be cost prohibitive and, unless a

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<sup>47</sup> This concern was raised by a number of other commenters. *See, e.g.*, UBS.

<sup>48</sup> ICI, SunTrust, Mainsource, Woodlands, CMFI, American Bar Association, SPARK, Chapin Davis, M&T Bank. *See also* Reich & Tang. The Financial Information Forum stated that sweeps would be possible in the retail context with certain modifications to the exemption.

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centralized industry wide clearinghouse is established to aggregate and track all such transactions, completely impossible to enforce outside its own systems.”

- **M&T Bank:** “Omnibus accounts are an efficient tool for an intermediary to purchase and sell mutual fund shares and are pervasive in the industry; they are also largely opaque. While the Commission is correct in its observation that funds already deal with this lack of transparency in applying other rules, those other rules lack the ‘existential’ quality of the \$1 million, ‘direct or indirect’ redemption limit applicable to a ‘retail’ money market fund. The redemption limit creates its own set of risks that must be understood, allocated and managed, and the Commission has not yet provided insight into what ‘reasonably designed’ procedures to enforce the limit would resemble. Boards of trustees may balk at the additional responsibilities, the procedures will add compliance and operational costs, and intermediaries may simply refuse to do business with smaller fund families if, as is likely, the intermediaries are expected to shoulder the bulk of the compliance burden and risk.”
- **Chapin Davis:** “As a practical matter, we anticipate that using an approach as described in the Release to allow a MMF to look through brokers and other intermediaries to each ultimately beneficial owner of shares to determine the \$1 million daily redemption limit per shareholder will be far more difficult to implement than anticipated by the Release.”
- **American Bankers Association:** “According to many of our bank fiduciaries, including those that have significant trust departments, it would be prohibitively expensive and time-consuming for the bank to determine whether an individual account within the omnibus account has breached the \$1 million threshold. Such a determination would very likely require additional systems or modifications to existing systems. Due to these additional costs, fiduciaries would be very likely to switch investments to government MMFs.”

Many of the commenters who supported Alternative One or the retail exemption argued for modified and/or broader exemptions than currently provided in Alternative One, such as exemptions for tax-advantaged accounts, a higher daily redemption level for all accounts, a prior



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notice exception to the limit, tracking based on Social Security numbers or maximum account balance.<sup>49</sup> In the words of commenters:

- **Vanguard:** “We believe that the daily redemption limit for investors in a stable NAV prime MMF should be raised from \$1 million to \$3 million. If the daily redemption limit is not raised, we believe certain exceptions would be necessary to make the \$1 million daily redemption limit less disruptive to ordinary retail shareholder activity. Regardless of the dollar limit on redemptions, however, we believe redemptions in retirement plan accounts and other tax-deferred savings accounts should be deemed ‘retail’ activity.”
- **Schwab:** “We recommend that the daily redemption limit for retail investors, which serves as the dividing line between ‘institutional investors’ and ‘retail investors,’ be increased from \$1 million to \$5 million per business day. The \$1 million redemption limit could significantly impact retail investors by triggering unexpected violations of the threshold and presenting a host of operational challenges. Those challenges, as well as the likelihood of inadvertent violations of the threshold, decrease markedly at the \$5 million level.”
- **ICI:** “We have significant concerns, however, that the SEC’s proposal to define retail funds through a daily redemption limit would impair investor liquidity and be more onerous operationally than other methods. Instead, we recommend the use of a U.S. Social Security Administration (“SSA”) issued social security number (“SSN”) as the fundamental characteristic to identify an investor eligible to invest in a retail money market fund.”<sup>50</sup>

More recently, Charles Schwab, Vanguard and certain other MMF sponsors filed a joint letter (which they note does not supersede prior comment letters from the individual sponsors) proposing a revised standard for classifying a fund as “retail,” to mean a fund that limits beneficial ownership interests to natural persons. We appreciate that these commenters are advocating on behalf of their customers in proposing to exempt certain groups of users or

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<sup>49</sup> Lyons & Bolek LLP, Vanguard, Schwab, ICI, American Benefits Council, USAA, ACLI, DCIIA, Financial Services Roundtable, SPARK, American Bar Association, Mutual Fund Directors Forum, Committee on Capital Markets Regulation, Reich & Tang, TIAA-CREF, Financial Services Institute, Financial Information Forum.

<sup>50</sup> See also SIFMA (suggesting that either Social Security Numbers/Tax Identification Numbers or a minimum initial investment threshold could be used to distinguish retail from institutional investors).

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transaction types from the difficulties associated with retail exception. It should not be lost on the Commission, however, that this new proposal does not alleviate the tax, accounting, or operational burdens associated with the floating NAV – it only attempts to limit these burdens by limiting the floating NAV’s application to fewer investors. These concerns would be eliminated altogether if the Commission, instead, chose to retain the stable NAV option and the amortized cost method for all MMFs and focus its efforts on refining Alternative Two, which, together with enhanced disclosures, provides the most effective means of achieving the Commission’s reform goals. We expect that if the Commission makes changes to any of the proposals prior to adoption, the Commission would issue an amended proposed rule to provide interested parties the opportunity to review the operational implications of any modified approach.

## **II. Alternative Two**

### **A. Many commenters expressed support for Alternative Two as the only option that would address the Commission’s concerns.**

As proposed, Alternative Two would require the imposition of a 2% liquidity fee if a MMF’s weekly liquid assets falls below 15%, subject to a board’s discretion to not impose the fee, to impose a lower fee, or to suspend redemptions for a period of not more than 30 days. Federated’s letter of September 16, 2013 provides detailed comments on the Commission’s proposal.<sup>51</sup>

Federated and a number of other commentators have discussed why Alternative Two of the Proposals is the only proposal currently under consideration that would directly address the Commission’s concern regarding the risk of large-scale redemptions from a prime MMF. Board authority to temporarily suspend redemptions would allow MMFs to withstand periods of heavy redemptions while preserving the utility and day-to-day operational efficiency of MMFs for investors and also maintaining MMFs as a source of short-term financing for corporate and governmental issuers. The following are some of the representative comments on these issues:

- **Independent Directors Council:** “The liquidity fees and gates alternative may be the better option because it would address the Commission’s core concern regarding heavy redemption pressures on money market funds during times of fund and market stress

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<sup>51</sup> See Letter from Federated to SEC (September 16, 2012) (titled “Comments Regarding Proposed Alternative 2”).

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without radically changing the fundamental characteristics of these funds for their shareholders.”

- **Wells Fargo:** “The fees and gates proposal strikes a more appropriate balance of costs and benefits while largely preserving the most valued features of money market funds.”
- **J.P. Morgan:** “We believe that the best option for achieving the SEC’s objectives is a variation of the fees and gates alternative . . . .”
- **Davenport** (a securities broker-dealer and investment advisor): “If the goal is to limit runs on MMFs, we believe Alternative 2 is the better solution. Because its restrictions will apply only when needed – on the very rare occasion when 7-day liquidity drops below a threshold amount – Alternative 2 has the benefit of preserving the essential characteristics of MMFs, while also giving MMF boards the tools to stop a run if necessary.”
- **Invesco:** “Alternative 2, when coupled with the enhanced disclosure requirements proposed . . . represents the best balance of the cost benefit factors.”
- **Deutsche:** “DIMA believes that the Liquidity Fee/Temporary Gate proposal alone would be the most effective option to achieve the Commission’s stated policy concerns . . . . [It] would be the least costly and disruptive to the markets and provide the most flexibility among investors.”
- **Dreyfus:** “We believe standby liquidity fees and redemption gates are reasonably designed tools to help CNAV MMF boards manage times of severe redemption pressure.”
- **Fidelity:** “[S]tandby liquidity fees and redemption gates present the most effective means to achieve the SEC’s ultimate goal of stopping significant redemptions during times of unusual market stress, and at the same time preserve the fundamental characteristics of MMFs, including the stable NAV structure.”
- **Plan Investment Fund:** “We wholeheartedly support the alternative set forth in the proposal that would grant authority to the fund’s board of directors to suspend redemptions for a given period of time during severe market turbulence.”

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- **ICI:** “Many of our members support liquidity fees and temporary gates because they promise to slow or stop significant fund outflows. Importantly, liquidity fees and temporary gates are only triggered when a fund is facing unusual circumstances, such as a period of heavy redemptions associated with general stress in the financial markets at large, or with an idiosyncratic credit issue. During normal market conditions, these tools are not used or needed. . . . The liquidity fee/temporary gate proposal also offers other advantages. Former Commissioner Paredes noted, ‘the prospect of having to pay a fee to redeem or of being prohibited from redeeming makes the risk of investing in money market funds more transparent to investors.’ The liquidity fee/temporary gate proposal, therefore, ‘advances the objective of the floating NAV proposal to sensitize investors to the fact that money market funds are not risk free’ without eliminating the stable NAV.”
- **State Street:** “SSGA opposes the adoption of liquidity restrictions on its clients. However, SSGA concedes that a fees and gates approach is more likely than other proposals to halt a ‘run’ on money market fund. . . . We are not aware of any way that would more effectively or definitively halt redemptions from a money market fund than a redemption gate.”
- **Independent Trustees/Federated Funds:** “It is our view that voluntary gating is the only proposed reform that would in fact stop runs and, based on our experience with the Putnam transaction in 2008, it has been tested and it works.”
- **U.S. Bancorp:** “We do believe that the gating proposal would be the most effective option in addressing run risk. . . . We do not believe a standby liquidity fee would deter shareholders from redeeming their shares in a time of extreme market stress.”<sup>52</sup>

Alternative Two was supported by numerous other commenters.<sup>53</sup>

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<sup>52</sup> U.S. Bancorp also noted, “Programming costs to implement the fees on MMFs would be significant despite the infrequency with which funds would likely make use of the functionality in the transfer agent system. . . . “[A]s with gating, private polling and anecdotal evidence of investor sentiment suggest that any liquidity restrictions placed on MMFs would meaningfully reduce the perceived benefit of MMFs for investors.”

<sup>53</sup> Chamber-CCMC, ICI, FSR, Mutual Fund Directors Forum, Invesco, Angel Research Paper, Fein, Reich & Tang, Artie Green, Financial Services Institute, Davenport, Chapin Davis, Cumberland Valley, Garst, Edwardsville, Chemung Canal, Barnard, Hepburn, Bramen, California Association of County Treasurers and Tax Collectors, Page, Lupinacci, Square 1, Stradley Ronon, Ropes & Gray, FIA, M&T Bank, SunTrust, MainSource Bank, Woodlands Bank, United Bank, TIAA-CREF, Santoro, Schapiro, Cleco. Schwab, which supported Alternative One, also stated

Footnote continued on next page

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**B. Some commenters raised significant concerns about Alternative Two, which is why Federated proposed modifications to the Commission’s proposal.**

As discussed below, a number of commenters opposed Alternative Two, for varying reasons.<sup>54</sup> Various commenters stated their belief that no further structural reform is necessary, and that investors simply will not tolerate a loss of liquidity or access to their funds. Representative comments include the following:

- **Government Finance Officers Association:** “Adopting a proposal that would impose liquidity restrictions on MMF investors at a time [of] fiscal stress will drive state and local MMF investors away from MMFs due to concerns about liquidity and potential losses that could result during such times.”
- **National League of Cities:** “[I]mposing redemption restrictions on prime money market funds would reduce their attractiveness as a cash management tool . . . .”
- **Virginia Treasurer:** “Gating could stop a run or excessive demand to redeem shares because it simply removes access to the MMF. [But] the knowledge that a fund may limit access at some point as liquidity conditions deteriorate also only heightens the risk of a run as it gives an incentive for fund investors to get out before a fund is gated.”
- **Independent Trustees/North Carolina Capital Management Trust:** “We strongly oppose this proposal. [Our municipal agency investors] require immediate access to their funds in order to finance their daily operations.”

Some commenters argued that if a floating NAV is effective in altering investor’s views of MMF risk, fees and gates would not be necessary.

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that it supported giving a MMF board the authority to impose a liquidity fee or gates “if a fund is under serious stress and heading towards liquidation.”

<sup>54</sup> See, e.g., Kentucky Treasurer, Committee on Capital Markets Regulation, HBS, McCulloch, Federal Reserve, Chicago Treasurer, San Diego Treasurer, Americans for Financial Reform, Chang, Edward Jones, Financial Information Forum, Thrivent, Capital Advisors Group, Crane Data, Committee of Annuity Insurers, Boeing, Novelis, State Street, Connecticut Treasurer, Vanguard, Oppenheimer, American Benefits Council.

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- **T. Rowe Price:** “We agree with the SEC that if the floating NAV significantly changes investor expectations regarding money market fund risk . . . the imposition of fees and gates should not be necessary.”<sup>55</sup>

Some commenters argued that the prospect of fees or gates would invite close monitoring by certain investors and generate preemptive runs whenever investors believed the imposition of a fee or gate was imminent, or even possible:<sup>56</sup>

- **Mutual Fund Directors Forum:** “[A]s the Commission’s proposal seems to recognize, this alternative does include the risk that sophisticated investors may be able to predict when a fund is approaching the point of triggering liquidity fees, and thus may time redemptions accordingly. Despite the possible structural weaknesses of this approach, we support offering the liquidity fees alternative as an option if the Commission intends to change the manner in which money market funds are regulated.”
- **Federal Reserve Banks:** “This option does not eliminate the run risk as investors could have an incentive to redeem *before* their fund breaches the WLA threshold . . . .”
- **Kentucky Treasurer:** “[We] would liquidate before a fund reached the trigger for liquidity restrictions and would liquidate all prime fund holdings in order to assure access to the State’s money. . . . [T]he existence of a trigger for possible liquidity restrictions may create a run on funds.”
- **Americans for Financial Reform:** Imposition of a liquidity fee or gate “may simultaneously trigger runs on other MMFs holding related assets which have not yet imposed withdrawal limitations. In addition, prior to imposition, the anticipation of a future withdrawal restriction may create incentives for investors to withdraw funds before the restriction is imposed.”
- **Systemic Risk Council:** “The ‘Gates and Fees’ could make the situation worse by moving up the run.”

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<sup>55</sup> T. Rowe Price said, however, that if the SEC adopts Alternative Two, a MMF board should be provided full discretion to determine when and if they should impose fees and gates.

<sup>56</sup> Goldman, Kentucky Treasurer, Mutual Fund Directors Forum, American Bankers Association.

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Federated shares these concerns, and, therefore, believes the modifications it and a number of other commenters have proposed are necessary in order to make Alternative Two work as contemplated by the Commission and minimize its potential adverse effects.<sup>57</sup> The modifications Federated proposed include: (1) reducing the 15% threshold to 10%; (2) reducing the maximum temporary suspension period to 10 days; (3) permitting a board to implement a liquidity fee or redemption suspension before the end of the business day if it determines there is a risk that weekly liquid assets will be reduced to less than 10% or it determines that action is appropriate to avoid material dilution or other unfair results to shareholders; (4) stating in any adopting release that the Commission expects boards will impose fees or redemption suspensions rarely and for only so long as necessary to protect shareholders; and (5) exempting tax exempt MMFs from these provisions, as the proposal does for government MMFs.

In conversations with its clients, Federated has allayed many client concerns by explaining the rare circumstances in which redemptions might be suspended or subject to fees to protect the interest of shareholders. These tools should be viewed (as Federated believes they are intended) as enhancements to a board's current authority under Rule 22e-3 to allow a board to take action to protect shareholders of a MMF under stress, without being forced to liquidate the MMF. This is why a statement of the Commission's expectations is so important and why Federated agrees with commenters about the importance of educating MMF users about the scope and intent of the provision for temporary suspensions of redemptions and liquidity fees:

- **Invesco:** “[A]dditional education about the purpose and operation of the proposed liquidity fees and redemption gates and the circumstances in which they might be implemented would increase greatly MMF investors’ willingness to accept them.”
- **Blackrock:** “We believe that any gating or liquidity fee rule will require significant investor education. From our discussions with clients, investors are confused about the current powers of Boards and how they would change. Given that the concept is to provide liquidity (albeit at a cost), we believe investor education could change their responses.”

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<sup>57</sup> Letter from Federated to SEC (Sept. 16, 2013) (titled “Comments Regarding Proposed Alternative 2”). *See also* Dreyfus, U.S. Bancorp (“[W]e would staunchly support allowing each fund’s board of directors to determine whether a gate and/or fee is in the best interest of shareholders.”). Two commenters proposed modifications to Alternative Two similar to Federated’s proposals. Florida CFO, George Mason Mercatus Center.

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### III. Impact on State and Local Governments

Arnold & Porter's September 13, 2013 letter on behalf of Federated warned of the impact of the Commission's proposals on state and local governments, both as investors in prime MMFs who rely on MMFs as one of the only remaining permitted investments for their cash balances, and as issuers of short-term debt who are dependent upon the continued attractiveness of tax-exempt funds to investors.<sup>58</sup> Federated also explained the special characteristics of tax exempt MMFs and of the short-term municipal market that suggest tax exempt funds should be treated like retail or government funds under the Commission's proposed rule: they offer a unique opportunity to earn tax-exempt income on cash balances; they are less dependent on market liquidity than prime or even government MMFs because of the nature of their portfolio holdings; and they are subject to additional legal and market constraints that would cause regulations limiting permissible investments to have a greater impact on tax exempt funds than on prime or government MMFs. Tax exempt MMFs weathered the financial crisis without support from their sponsors or liquidity facilities from the Federal Reserve, and the Commission has acknowledged that tax exempt MMFs were not a source of the problems encountered during the financial crisis. As a result, Federated has stated that neither Alternative One nor Alternative Two should apply to tax exempt MMFs.<sup>59</sup> Numerous commenters agree.

As they have in other forums, state and local government users voiced strong opposition to the Commission's floating NAV proposal.<sup>60</sup> Their views are highlighted below.

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<sup>58</sup> Letter from Arnold & Porter LLP to SEC 38-43 & App'x 2 at 10-12 (Sept. 13, 2013) (titled "Problems with the Floating NAV"). *See also* Letter from Federated to SEC (Sept. 16, 2013) (titled "Comments Regarding the Proposed Regulation of Tax-Exempt Money Market Funds"); Letter from Arnold & Porter LLP to SEC 38-41 (Sept. 17, 2013) (titled "Costs of Implementing the Proposals").

<sup>59</sup> Federated also stated that the "25% basket" for providers of guarantees and demand features should be retained for tax exempt MMFs and that compliance with a daily liquid asset requirement would not be feasible for tax exempt funds.

<sup>60</sup> *See, e.g.*, Mayor and City Council of Cincinnati, Chicago Treasurer, Massachusetts Treasurer, Virginia Treasurer, Government Finance Officers Association, TexSTAR, San Diego, Government Finance Officers Association and Public Sector Signatories, NJSLM, U.S. Conference of Mayors.



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**A. Commenters stated that tax-exempt MMFs should not be subject to either Alternative One or Two.**

Numerous commenters observed that tax exempt MMFs do not contribute to systemic risk and should not be subject to either the floating NAV proposal (with a “retail” exemption that is ineffective in exempting all tax exempt MMFs, as discussed above) or liquidity fees and gates. Comments included the following:

- **42 Members of Congress:** “We believe that municipal MMFs are similar to Treasury and government funds and should likewise be exempt from further regulations. Importantly, municipal MMFs are not vulnerable to heavy investor redemptions during times of financial stress. In fact, municipal MMFs remained remarkably stable during the financial crisis of 2008 with only modest outflows. Moreover-with only \$270 billion of assets-municipal MMFs are a small fraction of the MMF industry and in no way pose a systemic risk to the financial system. Municipal MMFs are extremely liquid investments, typically holding more than twice the SEC-required level of weekly liquid assets. Finally, the holdings of municipal MMFs have very high credit quality requirements as a result of existing regulations that restrict the type of debt they can hold.”
- **Vanguard:** “We believe that the Proposal correctly concludes that government and Treasury MMFs do not require structural reforms. . . . We believe the Proposal mistakenly concludes, however, that municipal MMFs warrant the same reforms as prime MMFs, without any evidence that such funds have a history of destabilizing, widespread redemptions.”
- **Legg Mason:** “We see no evidence that would justify the application of the fundamental changes under the Proposal to tax-exempt funds, and imposing those changes may result in undue disruption to tax-exempt funds.”
- **Northern Trust:** Tax exempt funds “should be able to retain a stable value and should not be subjected to liquidity fees and redemption gates.”
- **Independent Trustees/Federated Funds:** “Municipal money market funds exhibited none of the issues giving rise to the policy concerns expressed in the Proposal and don’t involve even the appearance of systemic risk. There is, therefore, no reason to injure or disrupt the short term municipal markets.”

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- **Dechert:** “[M]unicipal money funds have not been susceptible to the type of heavy redemptions that the Commission is seeking to limit. This was demonstrated during the 2008 financial crisis, during which municipal money funds did not experience unusually high redemption levels. Accordingly, municipal money funds have not been shown to present the type of systemic risk to which Alternative 1 is directed.”
- **Financial Services Roundtable:** “FSR believes that Municipal Funds should be expressly exempt from the floating NAV requirement for the same reasons the Commission has proposed to exempt government MMMFs. Because these funds are primarily invested in assets characterized by low credit risk and high liquidity, they do not present the same risk characteristics and redemption pressures as prime institutional MMMFs.”

**B. State and local governments oppose the Commission’s Alternative One because they rely on MMFs for cash management and are often statutorily barred from investing in fluctuating investment products. Many oppose Alternative Two as proposed because the imposition of a liquidity fee or gate would threaten users’ access to cash and stability of principal.**

State and local governments rely on MMFs to invest their operating cash. Regardless of whether floating NAV MMFs could continue to offer same-day settlement, state and local governments are often subject to legal or investment restrictions that would prevent them from investing in floating NAV MMFs at all. These users value stability of principal and ready liquidity, and as a result many wrote that they would be unlikely to invest in a MMF in which a liquidity fee or gate may be imposed.<sup>61</sup>

State and local governments have commented that they have few alternatives to prime MMFs for their operating cash. Because of the large cash balances state and local treasurers are administering, they have commented that they will not fit within the Commission’s exemption for retail funds, as they routinely redeem in excess of \$1 million on a given day. For many state and local government users, bank deposits do not present a viable option either. Not only do the balances of these users routinely exceed the \$250,000 FDIC insurance limit, but commenters explained that banks often are reluctant to accept public cash balances due to state law

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<sup>61</sup> Virginia Treasurer, Massachusetts Treasurer, Government Finance Officers Association, San Diego Treasurer, National League of Cities, Florida CFO, Government Investment Officers Association and State Treasurer Signatories, Kentucky Treasurer.

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requirements that the balances be collateralized at up to 110%.<sup>62</sup> State and local commenters also questioned whether government MMFs would be able to absorb the anticipated influx of prime MMF assets if the floating NAV for institutional prime MMFs is adopted,<sup>63</sup> and pointed out that the influx of prime fund assets into government MMFs would “drive rates lower, even causing negative returns when transaction costs are included,” resulting in a loss of income to state and local governments.<sup>64</sup> As these commenters explained:

- **Chicago Treasurer:** “We use the income from our cash investments to help pay the cost of providing services to our citizens. Less income on our invested cash means fewer services, and makes our tight budgets even tighter. In total, state and local governments hold approximately \$92 billion in MMFs. If we are restricted to investing only in government MMFs, the lost income to state governments amounts to many millions of dollars per year. We make good use of that income and we will have to further tighten our budgets if it is no longer available to us.”
- **California Association of County Treasurers and Tax Collectors:** “If the institutional prime funds that we are currently using for these purposes are forced to strike a net asset value at something other than \$1.00 per share, then the imprecise value of the proceeds of a sale would materially interfere and interrupt the liquidity management of participating counties. California's County Treasurers follow strict state laws governing how counties invest public money; security and liquidity are required features of any financial tool utilized by Counties. The proposal before you will be disruptive to Counties' ability to access funds needed to conduct the daily business of running a County and acting as Treasurer for myriad other public agencies and special districts that participate in our county pools.”
- **West Virginia Board of Treasury Investments:** “Exempting government funds from the floating NAV proposal is likely to result in a significant inflow of new investments in the funds. We believe that it is highly likely that government funds would be unable to absorb this volume of new investments and would have to close themselves to new investors seeking an investment alternative with a stable value.”

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<sup>62</sup> See, e.g., Ga. Code Ann. § 45-8-12, O.R.S. Ch. 295, Tex. Gov't Code Ann. § 2257.022. See also West Virginia Board of Treasury Investments, Virginia Treasurer, Georgia.

<sup>63</sup> West Virginia Board of Treasury Investments.

<sup>64</sup> Utah Treasurer.

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- **Metropolitan Mayors Caucus and Signatories:** “While we support regulatory efforts aimed at reinforcing the viability and liquidity of MMMFs, forcing MMMFs to move to a floating NAV under the present proposal has the potential to drive investors away from MMMFs, preclude their use for many public entities, and ultimately eliminate their utility for local governments. . . . Cities forced out of using MMMFs could face more risk with other cash management alternatives. For example, investors purchasing individual securities directly rather than through MMMFs lose the benefits of credit diversification. Other, less regulated cash vehicles provide less transparency for regulators and investors. Increased cash investment in bank products would concentrate risk.”
- **Government Finance Officers Association Joint Letter with Public Entity Signatories:** “State and local governments and other issuers are very concerned with the questions posed in the proposed rule release as to whether the SEC should adopt a rule that would change the fixed net asset value – the hallmark of MMMFs – to a floating net asset value. We believe that such a move would be harmful to state and local governments and the entire MMMF market. The fixed NAV is the trademark of MMMFs and changing its structure likely would eliminate the market for these products, leading to fewer investors of municipal bonds, and forcing state and local governments to divest their MMMF holdings.”
- **San Diego Treasurer:** “We are concerned with the impact of the supply and demand forces on the non-prime fund money market funds with the of the adoption of either of these alternatives. If many money market fund participants are driven to these exempt funds, similar to our experience, we fear that yields would be significantly reduced and/or purchases would be subject to daily limits.”
- **Government Finance Officers Association:** “The GFOA is wary about how this alternative proposal would impact state and local government investors. Adopting a proposal that would impose liquidity restrictions on MMMF investors at a time fiscal stress will drive state and local MMMF investors away from MMMFs due to concerns about liquidity and potential losses that could result during such times. We believe that this alternative is unnecessary given the additional fund reporting requirements adopted in 2010, which, coupled with the enhanced disclosure and transparency requirements included the SEC’s broader 2013 MMMF reform proposal should be sufficient to increase investor awareness of the market-based value of a fund’s asset[s] and reduce

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fund susceptibility to heavy redemptions, without imposing potentially significant costs on state and local governments.”

- **Connecticut Treasurer:** “While I applaud the SEC's goal to protect investors, I respectfully urge the SEC to not move forward with this proposal. Imposing a liquidity fee under any circumstance changes the nature of a money market fund and may disrupt the market for these investment vehicles.”

**C. State and local governments, as issuers, also opposed reforms that would shrink the size of tax exempt MMFs, and as a result, diminish the role of MMFs as key purchasers of short-term public debt.**

State and local governments raise significant funds through short-term debt. MMFs purchased 72 percent of the approximately \$500 billion state and local short-term debt outstanding as of April 2013.<sup>65</sup> Many state and local governments and their associations explained that they will face higher financing costs as the size of the MMF industry shrinks under the Commission’s proposals.<sup>66</sup> These issuers, as well as the majority of other commenters who addressed the issue, advocated for an explicit exemption from both Alternatives One and Two for tax exempt MMFs, in order to maintain the attractiveness of municipal MMFs.<sup>67</sup> Commenters also questioned the Commission’s proposed unequal treatment of government and municipal funds, pointing out that the proposal would have the effect of promoting the ability of the federal government to borrow at the expense of state and local governments.<sup>68</sup> Commenters

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<sup>65</sup> According to ICI data.

<sup>66</sup> 42 Members of Congress, N.H. Governor Margaret Wood Hassan, Chicago Treasurer, North Carolina Treasurer, Massachusetts Treasurer, Virginia Treasurer, LPPC, Government Finance Officers Association, Governor Deval Patrick, Government Finance Officers Association and Public Sector Signatories, Harford County; National Association of College and University Business Officers, NASACT, Rhode Island Treasurer, Pima County, Metropolitan Mayors Caucus and Signatories, City of Brockton, Connecticut Treasurer, Government Investment Officers Association and State Treasurer Signatories, Massachusetts Municipal Association, NH, NHCUC, Omaha, RI 8/27, Utah Treasurer, NYSAC, North Carolina Metropolitan Mayors, Keener, Greater Pittsburgh Chamber.

<sup>67</sup> 42 Members of Congress, N.H. Governor Margaret Wood Hassan, North Carolina Treasurer, LPPC, Government Finance Officers Association, Governor Deval Patrick, Connecticut Treasurer, National Association of College and University Business Officers, Government Finance Officers Association, Rhode Island Treasurer, Metropolitan Mayors Caucus and Signatories, NH, NHCUC, Omaha, RI 8/27, SIFMA, SunTrust, ICI, Legg Mason, Vanguard, Schwab, Dechert, Committee on Capital Markets Regulation. Wells Fargo advocated an explicit exemption for municipal funds from the floating NAV proposal, rather than the Commission’s proposal as a whole.

<sup>68</sup> Government Finance Officers Association, Governor Deval Patrick; Harford County Treasurer.

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explained the impact of the Commission's proposals on public and private borrowing costs as follows:

- **Government Finance Officers Association:** "The GFOA is also troubled with the proposed rule's deviation from parity between U.S. government and state and local government financing. The proposed rule would allow money market funds that invest largely in Treasury and U.S. government agency securities to continue to use a stable NAV. However, institutional tax-exempt funds that invest in state and local government securities would be required to float their NAVs. This lopsided treatment favors financing for the federal government and its agencies over the funding needs of state and local governments, which are no less pressing or important to taxpayers. Municipal securities are the second safest investment, aside from U.S. Treasuries, with state and local governments having nearly a zero default rate. The SEC should not grant one level of government finance advantages over another in its rules."
- **Massachusetts Municipal Association:** "If the municipal bond market becomes less attractive to investors due to changes in the MMMF market, state and local borrowing costs would increase significantly. This would have a major chilling effect on local capacity for growth and development. Because MMMF demand and municipal bond demand are linked, it is essential to retain the attractiveness and stability of fixed NAV MMMFs."
- **National League Of Cities:** "[A] floating NAV or redemption restrictions on municipal money market funds would cause local governments to pay more to borrow money to finance the construction of basic infrastructure such as schools, roads, bridges, sewers and hospitals. Tax-exempt money market funds play a crucial role in public finance, as they currently hold almost three-fourths of the short-term securities issued by state and local governments (72 percent in April 2013). These funds are attractive to their investors because they realize the tax benefit of the underlying municipal bonds. A floating NAV or fees and gates would result in fewer funds purchasing short-term municipal securities; thus, increasing costs for local governments as demand for their tax-exempt securities is diminished. By making money market funds less attractive to investors, and increasing the cost of capital for state and local governments, the Commission would cause less investment in infrastructure at a time when jobs are scarce and the physical condition of public works is deteriorating."

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- **ICI:** “Absent clear evidence that tax-exempt money market funds are susceptible to substantial redemption pressure or pose some manner of systemic risk, the proposed reforms are inappropriate and unnecessary for these types of funds. Moreover, they potentially would compromise the critical role that these funds play in providing affordable short-term funding for state and local entities across the United States.”
- **SIFMA:** “Despite their modest asset levels, municipal money market funds serve a disproportionately important role in the financing of state and local governments. Accordingly, the Commission should avoid fundamental reforms that will make these funds less attractive to investors. State and local governments and agencies issue municipal securities to finance hospitals, education, transportation, housing and many other projects that are critical to the infrastructure and functioning of the country. Money market funds, municipal money market funds in particular, help maintain a robust and active market for this state and municipal debt. . . . According to data as of June 30, 2013, municipal money market funds held the vast majority of municipal variable rate demand obligations and tender option bonds that were held by money market funds. If municipal money market funds shrink, demand for short-term municipal securities will decline, resulting in increased financing costs for state and local governments.”

**D. State and local governments warned that the Commission’s proposals would lead to administrative burdens and legal inconsistencies for many LGIPs.**

As discussed in our letter filed September 17, 2013 on behalf of Federated, the Commission’s proposed rule could indirectly impact state and local governments operating or investing liquid assets in local government investment pools, or “LGIPs,” which are subject to Government Accounting Standards Board (“GASB”) Standards rather than Rule 2a-7, but are permitted to value all of their assets at amortized cost if they conform to the requirements of Rule 2a-7.<sup>69</sup> In brief:

- Federated believes that the Commission fails to appreciate the relationship between Rule 2a-7 and the ability of LGIPs to continue to maintain a stable NAV, as well as what we believe to be an unwillingness of state and local governments to adopt a floating NAV requirement for LGIPs;

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<sup>69</sup> Letter from Arnold & Porter LLP to SEC (September 17, 2013) titled “Relationship to Local Government Investment Pools (“LGIPs”)”.



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- The most likely result of adoption of Alternative One is that LGIP accounting standards would be further de-coupled from an amended Rule 2a-7;
- State and local government balances would shift (under new rules adopted under Alternative One) from floating NAV MMFs to stable value LGIPs; and
- State and local governments (and GASB) will incur significant costs and administrative burdens in sorting through and resolving the accounting issues involving use of amortized cost accounting by “2a7-like” LGIPs.

State and local governments commented in detail on the effect of the Commission’s proposal on LGIPs. Commenters stated that the adoption of the proposals as currently drafted (particularly Alternative One) would impose a large burden on state and local governments and the GASB to address and resolve the relationship between the amendments and the use of the amortized cost method of accounting by external pools that operate as “2a7-like” LGIPs.<sup>70</sup> These users warned that the proposed rule would disrupt LGIPs by creating administrative burdens for states and localities attempting to reconcile Rule 2a-7, GASB Standards, and would set up conflicts with state laws requiring investment in stable value instruments.<sup>71</sup> State and local governments would also have to procure and implement accounting software capable of handling a fluctuating investment.<sup>72</sup> Rather than incurring additional costs and administrative burdens to accommodate the Commission’s proposal, these commenters confirmed that public sector funds simply would shift away from floating NAV funds and seek alternative investments, potentially with greater risk and less transparency.<sup>73</sup>

- **Government Finance Officers Association and Public Sector Signatories:** “If the SEC rules are changed to adopt a daily floating NAV, states would have to alter their

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<sup>70</sup> IPIM, Virginia Treasurer, Government Finance Officers Association and Public Sector Signatories, West Virginia Board of Treasury Investments, NASACT. *See also* Chamber-CCMC/TSI.

<sup>71</sup> Virginia Treasurer, Government Finance Officers Association and Public Sector Signatories, Harford County Treasurer, NASACT, Georgia Treasurer, Florida CFO; Government Investment Officers Association and State Treasurer Signatories.

<sup>72</sup> Virginia Treasurer, Government Finance Officers Association and Public Sector Signatories, Washington Treasurer, Government Investment Officers Association and State Treasurer Signatories.

<sup>73</sup> IPIM, North Carolina Treasurer, West Virginia Board of Treasury Investments, Georgia Treasurer, Government Investment Officers Association and State Treasurer Signatories, Utah Treasurer.



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own statutes in order to comply, as many state statutes cite Rule 2a-7 as the model for their management of the LGIPs. Such a change would introduce a complex set of difficulties in terms of daily accounting that neither the states nor their investors (local governments) are readily equipped to handle, and would require costly modifications to existing accounting systems, in addition to likely new layers of GASB compliance standards.”

- **Utah Treasurer:** “Establishment of a variable NAV will increase accounting costs significantly for our LGIP as we will need to pass through insignificant gains or losses on a daily basis to more than 600 public bodies that participate in the state's LGIP. . . . The natural reaction is to then look to other investments to meet this need in the portfolio. The options are higher concentrations in commercial paper, which carries concentrated credit risk, an illiquid secondary market, and extremely low returns when transaction costs are included. Bank deposits are an additional option, but they are paying next to nothing and banks are not looking for large deposits at this time. And of course, US Treasury obligations are always an option, but if outflows from MMFs move to UST Bills the demand will drive rates lower, even causing negative returns when transaction costs are included. The result will be many public treasurers taking on additional market and credit risk in order to enhance returns.”
- **Virginia Treasurer:** “[M]any governmental entities are not permitted by law to invest in funds that have fluctuating market values. Requiring LGIPs to daily value holdings will mean that their participants, without a change in their laws, will be unable to use LGIPs or money market funds as a short-term liquidity vehicle. This will create cash flow management issues for them and may force them into less liquid and lower yielding bank deposits or demand deposits. . . . It is doubtful that LGIP participants would be permitted to invest in a fund that could be subject to "gating." These investors are in LGIPs because of the immediate and full liquidity advantages they offer; without full liquidity they will either not invest or invest in much smaller amounts with the difference once again likely to go to lower yielding instruments or possibly demand deposits.”
- **West Virginia Board of Treasury Investments:** “We note that GASB could choose to de-link the use of amortized cost by state pools from some or all of Rule 2a-7. In addition, a state pool could choose to round unit prices to the nearest cent without using amortized cost to value all portfolio assets of the pool. If, however, the MMP were required to adopt a floating NAV, it is likely that local governments would withdraw their funds and redirect them to other alternatives that promise stable principal values.”

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- **Washington Treasurer:** “Though our \$10 billion LGIP could adapt to operating on a floating NAV basis, doing so would require system, accounting and procedural changes for many of our 400 local government participants that are still trying to recover from the financial crisis and who will never have the personnel or financial capacity to accommodate this level of accounting detail. This would be a disservice to our struggling local governments by yet again causing turbulence and uncertainty as their staff and systems deal with another round of rule, process and reporting changes. I ask that you keep these entities in mind as you structure your final proposal.”
- **Georgia Treasurer:** “Should the SEC adopt its proposed changes to Rule 2a-7 with an effective two-year phase-in period for MMFs, states would be at a distinct disadvantage that may prohibit continuation of any LGIP opting to be ‘2a-7 like.’ Since GASB regulations do not consider multiple options and exemptions for LGIPs to choose among in order to continue use amortized cost accounting, any consideration by GASB to amend its Statements 31 and 59 would take time to consider, possibly as long as two years. Georgia could not even consider policy or statutory changes until GASB determined whether to amend its current regulations. In addition, our state Legislature requires significant time to research and contemplate legislative changes.”

#### IV. Other Elements of the Commission’s Proposal

In a letter filed September 17, 2013, Federated provided comments in support of the Commission’s efforts to increase the transparency of MMFs, but explained that the proposals should be modified to be of more use to investors and markets. Federated also responded to other elements of the Commission’s proposal.<sup>74</sup> In brief, Federated, among other comments:

- Proposed that the disclosure requirements be further tailored to provide information that investors will find most useful on a regular basis, and to provide funds sufficient time to gather, validate, and format data before publishing it;

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<sup>74</sup> Letter from Federated to SEC (Sept. 17, 2013) (titled “Comments Regarding Amendments to Disclosure Requirements for Money Market Funds and Current Requirements of Rule 2a-7”).

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- Supported the aggregation of majority owned subsidiaries for calculating diversification, but opposed treating sponsors as de facto guarantors of asset-backed securities and the elimination of the “25% basket” for demand features and guarantees; and
- Stated that while clarification of stress testing requirements may be appropriate, required stress testing and reporting should not be expanded to a MMF’s board of directors or trustees.

Commenters who addressed the other elements of the Commission’s proposal, such as changes to MMF disclosures and reporting, diversification requirements and enhanced stress testing, were mixed in their evaluation. Some commenters took the position that the 2010 amendments to Rule 2a-7 require MMFs to provide sufficient disclosures to shareholders or otherwise commented negatively on the reforms.<sup>75</sup> Others expressed support for these elements of the Commission’s proposal.<sup>76</sup> Still others agreed that the Commission’s proposals contain many useful elements, but that the level of detail contained in some of the disclosures would be excessively costly and burdensome without a corresponding benefit to investors or systemic stability.<sup>77</sup> Many suggested that MMFs be provided additional time to make certain disclosures to ensure content accuracy.<sup>78</sup> In the words of these commenters:

- **Chamber-CCMC:** “While CCMC generally supports the Proposal’s enhanced disclosures, the Commission should take into consideration that certain of the proposed disclosures will be costly and time-consuming for MMFs to implement. With respect to the website disclosure requirements, internal systems and software would need to be upgraded or, for those MMF managers that do not have existing systems, third-party service providers would need to be engaged. The costs (which ultimately would be borne by investors through higher fees or lower yields) could potentially be significant to an MMF and higher than those estimated in the Proposal.”
- **State Street:** “State Street would like to stress that, based on our vast experience in filing the current Form N-MFP, five business days is barely adequate to ensure the

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<sup>75</sup> Virginia Treasurer, Government Finance Officers Association, Chang, Stradley Ronon, Crane Data.

<sup>76</sup> Barnard, Santoro, MSCI, Connecticut Treasurer, Angel Research Paper, Systemic Risk Council, Federal Reserve.

<sup>77</sup> NYC Bar, SIFMA, Chamber-CCMC, ICI, Mutual Fund Directors Forum, Waddell & Reed.

<sup>78</sup> Dechert, Stradley Ronon.

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accuracy and completeness of the data currently required in that Form. The addition of significant data points to Form N-MFP would very likely increase the risk of error and untimely filings. This issue is even more important considering that the staff has recommended that the current 60-day delay in releasing the information to the public would be removed, making the filing immediately available to the public. We would strongly recommend that the staff extend the current five business day filing requirement by one business day, or ideally two business days. This would allow service providers, advisers and others enough time to ensure that the significant amount of data is accurately and completely disclosed in the Form N-MFP in a timely manner.”<sup>79</sup>

- **Silicon Valley Bank:** “[W]e feel it is important to note the additional requirements of fund reporting, stress testing, concentration limits, etc. as positives for the industry. Investors require enough information to compare funds to alternatives and to assess risk/reward trade-offs for specific funds. As a general rule, increased disclosures assist in that process.”
- **Reich & Tang:** “As we have long maintained, the necessity for reform measures can be significantly diminished with shareholder education and increased transparency. Making the argument is not an endorsement for additional reform, rather a message to our peers whom favor providing additional value to shareholders by way of transparency. For example, the SEC requires money market mutual funds to post portfolio holdings at least monthly. Reich & Tang and certain other fund sponsors opt to provide this information to shareholders daily. Similarly, posting mark-to-market NAVs daily, while not required, is being done and we commend those that offer this increased level of transparency.”
- **Chapin Davis:** “Chapin Davis, Inc. also urges the Commission to scale back on the frequency and scope of the required disclosures and reporting. Although some of the information will be useful, the proposal calls for far more detailed and more frequent disclosures than needed and at the margin will increase MMF costs beyond the offsetting investor and market benefit. The Release estimates that it will require MMF sponsors 90,000 hours of staff time to change systems to be in a position to make the new disclosures and reports, and 45,000 additional hours of staff time per year to prepare and make these disclosures and reports. Someone will be paying for those staff salaries (or

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<sup>79</sup> State Street’s letter included detailed commentary on the costs and timing of the Commission’s proposed disclosures and enhanced stress tests.

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consultant, accountant and lawyer hourly rates). Those increased costs will ultimately be borne in large part by investors and portfolio issuers. In addition, to the extent that we as a brokerage firm are required to process, review or push out that information to our customer, there is an additional level of cost and burden—ours and our clients—that is not factored into the Commission's cost estimates. We do not think MMF investors will derive benefits equal to the cost of such a large amount of resources devoted to reporting and disclosure requirements. Accordingly, we respectfully suggest that these disclosures be scaled back in detail, timing and scope.”

Further, while aggregating parents and subsidiaries for purposes of diversification reflects a practice already followed by Federated and many other MMF managers, the other proposed changes to the diversification requirements would seriously impair the operations of MMFs or create arbitrary restrictions without contributing to the goal of investor protection.<sup>80</sup> The **ICI** objected to these proposed changes to the diversification requirements as well:

- “We do not support the SEC’s proposal to require money market funds (subject to an exception) to treat the sponsor of a special purpose entity issuing asset-backed securities as a guarantor of the securities . . . . Rule 2a-7 already counts toward a company’s diversification limit any asset-backed security for which the company actually provides a guarantee or demand feature. The proposal would change this result by treating a sponsor of an asset-backed security as a guarantor of the entire amount of the security held by the money market fund, even if the sponsor’s guarantee or demand feature is limited to a smaller amount or if the sponsor has no legal obligation to support its asset-backed security.”
- “We do not support the SEC’s proposal to eliminate the so-called ‘25 percent basket,’ which currently allows up to 25 percent of the value of securities held in a money market fund’s portfolio to be subject to guarantees or demand features from a single institution. Eliminating the basket would increase rather than decrease risk by increasing funds’ reliance on less creditworthy credit support providers and unduly decrease the flexibility currently afforded funds.”
- “We are concerned that further restricting diversification limits may only heighten this problem by potentially forcing money market funds to invest in less creditworthy

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<sup>80</sup> NYC Bar, ICI.

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issuers, which could increase the risk within money market funds' portfolios, rather than decreasing it."

Commenters also raised concerns regarding the proposed expansion of stress testing requirements.

- **Legg Mason:** "We do not believe that any expansion is necessary. There are limits to what stress testing can foretell, even when conducted and evaluated with the utmost diligence. Stress testing reports are already often lengthy and complex. The current program has worked reasonably well since 2010 to remind advisers and boards of the impact that external events can have on money market funds. That is, after all, the intention of the current requirements."
- **T. Rowe Price:** "We agree with the ICI's comment letter that further changes to the stress testing rules are unnecessary. Our current stress testing reports as mandated by Rule 2a-7 are robust and informative, covering what we believe are the major risks to a money fund (our typical board report summarizes five different stress tests and is 20 pages in length). We are concerned that adding additional tests on issues of lesser importance will detract from the stress testing and obfuscate the more important information. The SEC should not mandate further types of testing; rather, they should allow the board to determine what additional testing, if any, is necessary based on their interactions with the fund adviser and its risk management personnel."
- **Schwab:** "We oppose the proposed enhanced stress-testing requirements, because we believe that they will be difficult to comply with and provide little added benefit for understanding the risks in a money market fund."
- **Invesco:** "We believe that this additional testing is unnecessary and would create a substantial burden for MMF advisers while producing little valuable information for MMF boards due to the inherently speculative nature of most of the factors."
- **ICI:** "We do not support a dramatic overhaul of the current stress testing requirements. The SEC should consider the limitations of stress testing and of fund directors' capacity to review and interpret stress tests when reforming these provisions."

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## **V. Systemic Consequences and Costs.**

The direct and indirect costs of the proposals – particularly the floating NAV and the elimination of the amortized cost method of valuation – will be enormous. This is particularly concerning with respect to the floating NAV proposal, which has no offsetting benefits in terms of preventing or reducing large scale redemptions from MMFs. Many commenters agreed with Federated that current investors would reduce or outright eliminate use of MMFs as vehicles for cash management and investment. Commenters described multiple economic consequences that would result from the diminished role of MMFs in the financial system, and the shift of assets to other vehicles.

### **A. Likely Assets Flows Under the Floating NAV Proposal.**

Of the large number of comments filed on the Commission's proposed rule, no commenters stated that they would be more likely to invest in MMFs if the Commission's floating NAV proposal were adopted, nor did any commenters suggest that the funds will flow into MMFs as a result of the proposed reform. According to a survey conducted by Sungard of its customer base of treasury managers, insurance companies, hedge funds, public utilities, governments and universities, "85% of respondents reported that Alternative 1 would cause them to decrease their use of MMFs substantially or entirely," while only 4% "reported that Alternative 1 would result in their increased use" of MMFs.<sup>81</sup> Many commenters have stated, however, that they and/or their investors and clients are less likely to invest on MMFs if the floating NAV option were adopted and have estimated that MMFs will shrink as a result of the proposed reform.<sup>82</sup> As commenters explained:

- **Dreyfus:** "We anticipate that adopting a VNAV alternative will lead to substantial and permanent net outflows from MMFs."

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<sup>81</sup> Sungard.

<sup>82</sup> 42 Members of Congress, American Benefits Council, SIFMA, Chamber-CCMC, Angel Research Paper, ICI, American Bankers Association, Financial Services Roundtable, Association for Financial Professionals, Mutual Fund Directors Forum, TSI, ICI, Connecticut Treasurer, New Hampshire Treasurer, Georgia Treasurer, Metropolitan Mayors Caucus and Signatories, NHCUC, Omaha, Kentucky Treasurer, Rhode Island Treasurer, Utah Treasurer, Government Finance Officers Association and Public Sector Signatories, U.S. Conference of Mayors, W.M. Case, Keener, Edwardsville. We are aware of only one commenter, Thrivent, that questioned whether the shift to a floating NAV would drive assets out of MMFs.

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- **Fidelity:** “[F]undamental changes to the stable NAV structure of MMFs will cause a significant number of individual and institutional investors to shift assets out of MMFs into banks and other short-term investment vehicles.”
- **J.P. Morgan:** “Many of these investors, based on their organizations’ objectives and investment guidelines, will not consider investing in a MMF with a floating NAV.”
- **UBS:** “While the benefits to be derived from Alternative 1 are somewhat speculative, Alternative 1 would impose significantly higher costs on money fund shareholders. . . . alternative 1 would require costly systems changes and would reduce the appeal to many investors.”
- **U.S. Bancorp:** “[Based on a survey of our prime fund investors] in excess of 80% reported a floating NAV would cause them to stop using prime funds altogether and seek other investment alternatives for their cash.”
- **Silicon Valley Bank:** “Our clients are focused on developing the world’s most exciting technologies and innovations. They see MMFs as vehicles that provide diversification of credit risk and the highest of liquidity thresholds. They have neither the time nor inclination to account for fractional movements in the underlying price of their cash positions. They, like many institutional investors surveyed about the reform proposal, would be significantly less likely to continue using MMFs and would choose alternative vehicles for their cash rather than adapt to the new accounting burdens.”
- **Cleco Corporation:** “From our perspective, we can say categorically that any rule that results in the withdrawal of the ability of prime funds to value their portfolio securities at amortized cost (hence assuring in most circumstances that purchases and redemption will not be effected at \$1.00 per share), will cause us to reassess our use of such funds and, in all likelihood, curtail or substantially cut back on their use.”
- **Pima County Treasurer:** “Many of our county treasuries do not have the resources that would be required to account for a floating NAV or the ability to recognize a loss on their investments. This rule change would eliminate our ability to use MMMFs as a cash management tool.”
- **Kentucky Treasurer:** “This fundamental change in valuation and accounting would notably discourage investors from purchasing a floating NAV money market fund by



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taking away the very characteristics that make a money market fund an attractive, stable investment.”

- **Blackrock:** “If [the floating NAV] proposal were adopted . . . our client survey showed approximately 48% of respondents who currently invest in a Prime institutional MMF would no longer use a Prime institutional MMF.”
- **Angel Research Paper:** “A large fraction of institutional money market fund users will stop or reduce using money market funds. The reduction in institutional prime money market fund assets could range from approximately \$200 billion to over \$950 billion if the floating NAV proposal is adopted.”
- **iMoneyNet:** “We recently surveyed our subscriber base on these issues . . . . Respondents overwhelmingly oppose any floating NAV option, as commenters to the SEC, FSOC, and numerous other forums in the past have also made clear.”
- **Sungard:** “Based on [our] survey results, we believe that either of the Commission’s alternative proposals would make MMFs substantially less attractive to our clients, would substantially diminish the use of MMFs by treasury managers and other institutional investors, and would increase the costs and lessen the efficiency of MMFs.”
- **Treasury Strategies:** “Based on interviews with broker-dealers and trust departments, we conclude [m]ost trust departments will not use floating NAV MMFs as a result of strict investment guidelines and operational challenges.”
- **American Benefits Council:** “Department of Labor regulations require participant-directed defined contribution plans that want to satisfy section 404(c) of ERISA to make available investments with a range of risk/reward characteristics. Under these regulations, the plan must offer a low risk investment. Money market funds serve this role in many plans—surveys of plan sponsors suggest more than half of plans include them in their investment menus. . . . It is possible that the floating NAV proposal, if implemented, would make a money market fund ineligible to serve as a qualified default investment alternative. Section 404(c)(5) of ERISA provides that a participant may be treated as having exercised control over his or her account even if the participant is defaulted into the investment, if the participant’s account is invested in accordance with regulations prescribed by DOL. Under current rules, a money market fund may qualify as a temporary QDIA for up to 120 days.”

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- **Chamber-CCMC:** “In addition to investment policies, U.S. businesses may have debt covenants or cash collateral, escrow or leverage agreements that require collateral to be invested in a stable NAV product. If the SEC adopts Alternative 1, U.S. businesses would need to examine those covenants and agreements to determine if a floating NAV would be a permitted investment and, if not, both parties to the covenant or agreement would need to agree to a change.”

**B. Likely Asset Flows Under Alternative Two.**

A number of commenters also stated that the imposition of the gates and fees proposal under Alternative Two would cause investors to leave MMFs subject to the proposals. For example, according to Sungard, “[a]pproximately 76% of respondents reported that Alternative 2 would cause them to decrease their use of MMFs substantially or entirely” while “[n]o respondents reported that Alternative 2 would result in their increased use of MMF.” Other commenters who addressed this issue include the following:

- **Connecticut Treasurer:** “To the extent that investors cannot be assured of access to their funds, they may invest in other options which may not have the inherent safety of a money market fund or may be inadvertently subject to other risks.”
- **Blackrock:** “[O]ur client survey showed that approximately 40% of our clients who currently invest in a Prime institutional MMF would no longer invest in MMFs that had standby liquidity fees and gates, and 37% who currently invest in a Prime institutional MMF would reduce their allocation to these funds. The vast majority (83%) indicated that their need for unrestricted access to liquidity was the major reason why this proposal is not appealing. We believe that any gating or liquidity fee rule will require significant investor education. From our discussions with clients, investors are confused about the current powers of Boards and how they would change. Given that the concept is to provide liquidity (albeit at a cost), we believe investor education could change their responses.”

Federated emphasizes, however, that Alternative Two, if appropriately modified and supplemented by investor education as to the very limited circumstances in which a temporary suspension or gate would be implemented, offers a far better opportunity for investor acceptance than the floating NAV option, which would impose continuous daily burdens on MMF users.

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### C. Likely Impact of Combining Alternatives One and Two.

Commenters were nearly uniform in opposing the combination of the two proposals, explaining that such a product would not be viable.<sup>83</sup> In the words of commenters:

- **Invesco:** “Alternative 3 effectively would destroy MMFs by combining the undesirable features of Alternative 1 with the significant liquidity restrictions of Alternative 2, thereby creating a uniquely undesirable product that no rational investor would select.”
- **Dreyfus:** “We believe adopting a VNAV in combination with the Fees and Gates . . . presents a worst-case scenario for MMF investors.”
- **Fidelity:** “A combined structure would impose excessive costs and burdens on the MMF industry, MMF shareholders, and the financial markets generally [and] would drive the greatest number of shareholders and fund providers out of MMFs.”
- **Oppenheimer:** “We do not believe that any rational investor would purchase a fund that is saddled with the combination of a floating NAV, the prospect of having to pay a fee to redeem shares or of being prohibited from temporarily redeeming any share, and the strict portfolio requirements imposed by Rule 2a-7, when other, less onerous, options are readily available.”
- **Wells Fargo:** “We strongly believe . . . that the combination of a variable NAV and Fees and Gates for prime institutional funds will lead nearly all investors to choose other options – further exacerbating the costs associated with a massive migration of assets to government money market funds and riskier and less-regulated alternatives.”
- **Blackrock:** “If one of the stated objectives of the further reforms is to preserve the benefits of MMFs and have a viable product for investors to use, this proposal [combination of liquidity fees and gates and a floating NAV] is not workable. A rational investor would not purchase a MMF with the strict portfolio requirements of Rule 2a-7, that has both a floating NAV and has the prospect of a liquidity fee and gate.”

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<sup>83</sup> American Benefits Council, Chamber-CCMC, American Bankers Association, Mutual Fund Directors Forum, ICI, SIFMA, Goldman, Wells Fargo, BlackRock, PFM Group, OFI Global Asset Management, Northern Trust, Vanguard, UBS, State Street.

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- **Goldman:** “While investors have expressed differing preferences between stability and liquidity, they have consistently told us that a combination of Alternative 1 and 2 could render money funds unworkable for most, if not all of them, since the combination effectively would mean that money funds offer neither stability nor liquidity (nor, in the current market conditions, yield). Without preserving one or both of the priorities of money fund investors, the combination, in our view, would lead to a mass exodus from money funds into alternative products.”
- **SIFMA:** “A fund subject to both fundamental reforms is not a viable product.”
- **ICI:** “The combination of the two SEC proposals will produce a kind of Zizzer-Zoof fund, lacking both the share price stability and the assured redeemability of today’s money market fund—the result, a fund which nobody will want because nobody will need.”
- **State Street:** “State Street remains strongly opposed to the Proposals suggested by the Commission, and believes that adoption of either proposal – or, worse, both – would have a significant negative impact on investors, advisers and financial markets.”

**D. Increase in the Cost of Financing.**

As discussed in our letter dated September 17, 2013 and submitted on behalf of Federated, because of the key role of MMFs as purchasers of short-term debt, 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.<sup>84</sup> Federated believes that, at a minimum, \$660 billion to \$750 billion in institutional prime MMF assets and \$54 billion in institutional tax-exempt assets will be driven to other short-term vehicles, forcing issuers to pay higher interest, extend the duration of their debt burdens, and/or resort to bank lending on less favorable terms.

Commenters who addressed the issue of short-term funding were nearly unanimous in warning that a diminished MMF industry, and in particular a sharp reduction in the assets under management of prime MMFs, will increase the cost of short-term credit for private-sector issuers

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<sup>84</sup> See Letter from Arnold & Porter LLP to SEC 38-41 (Sept. 17, 2013) (titled “Costs of Implementing the Proposals”).

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of commercial paper.<sup>85</sup> By raising the cost of financing for American business, these commenters observed the Commission's proposal would have a deleterious impact on the nascent economic recovery.

- **U.S. Chamber and Business Joint letter:** "The implications of a migration away from MMMFs extend well-beyond cash management within individual companies. Cash that companies invest in MMMFs provide a critical source of capital used to buy corporate commercial paper and short-term municipal securities. If a floating NAV dries up this capital source, it will rob the commercial paper and short-term municipal securities markets of a major source of short-term financing and disrupt the operations of companies and municipalities across the country."
- **Association for Financial Professionals:** "Considering the vast market share of corporate commercial paper purchased by MMFs, a shrinking money market fund industry would have a cascading effect of tightened liquidity on an important source of commercial financing. A shrinking commercial paper market could force large, creditworthy companies that are currently able to sell commercial paper into other areas of debt markets. As these companies enter or increase their borrowing through these debt markets, smaller and less creditworthy companies may no longer be able to raise sufficient capital or might see their borrowing costs increase due to increased competition for capital. Moreover, research indicates that bank lending lacks the capacity to replace the void that would be left by the \$1.37 trillion commercial paper market."
- **Chamber-CCMC:** "Requiring institutional prime money market funds to use a floating NAV would fundamentally alter the structure and nature of the affected funds by eliminating the critical attribute of stability that makes these funds an attractive and efficient cash management tool for corporate treasurers. As investments are withdrawn from these MMFs, they will largely disappear as a reliable source of short-term financing for U.S. businesses."
- **National Association of State Auditors, Comptrollers and Treasurers:** "Changes that affect the operation of these funds could have harmful repercussions in the market for municipal debt, making states pay higher issuance costs, which could ultimately impact

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<sup>85</sup> American Benefits Council, Chamber-CCMC, Greater Pittsburgh Chamber, Kentucky Chamber, Smithville, Angel Research Paper, Systemic Risk Council, ICI, Financial Services Roundtable, Association for Financial Professionals, U.S. Chamber and Business Joint Letter, Virginia Chamber, Sungard, Fein, Santoro.

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the economic recovery underway. Funds may curtail their municipal bond purchases, and investor interest in money market funds may wane, which could limit financing options available to state and local governments. Such actions could ultimately lead to higher financing costs, reduced services, increased taxes, and potential layoffs.”

- **Greater Durham Chamber:** “Further regulations that threaten to shrink the pool of money market mutual fund capital available to businesses will negatively impact their ability to meet their working capital needs, causing large disruptions in the nation’s economy and untimely job creation.”
- **Angel Research Paper:** “It is clear that the adoption of a floating NAV will cause a serious contraction in the assets in institutional prime MMMFs ranging from approximately \$200 billion to over \$950 billion. Such a major movement of assets from their preferred home to other places will be very costly. Commercial paper issuers will pay from approximately \$2 billion to over \$10 billion in additional interest costs, driving up the cost of capital for those issuers. MMMF investors will receive lower yields on their cash balances, ranging from approximately \$.26 billion to over \$1 billion annually. The massive flow of deposits into the banking system will cause a massive increase in required bank capital at a time when banks are already under pressure to meet the toughened capital requirements of Basel III. The banking system will need to raise between \$11.9 and \$89.5 billion in additional capital to meet the capital requirements caused by the influx of assets from MMMFs. The large increase in bank deposits will push down the interest that banks pay on all deposits, costing savers additional billions of dollars every year.”
- **Sungard:** “The SunGard survey also shows that 56% of respondents believed their funding costs would increase if the alternative proposals were enacted. Given the importance of MMFs throughout the US economy, and the manner in which they are used, such a result is both plausible and undesirable.”
- **Systemic Risk Council:** “By allowing stable NAV to remain for institutional government funds and floating NAV for institutional prime funds, the new rules will cause significant money to flow from commercial paper issuers to agency issuers. On a relative basis, this will artificially raise the cost of borrowing for corporations (whose debt is in the floating NAV ‘institutional prime’ space), and artificially subsidize borrowing by the Treasury and these government-sponsored entities (Fannie Mae, Freddie Mac and the Federal Home Loan Banks) whose debt is in the stable NAV “institutional government” space. At a time when the government should be working to

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reduce government subsidies which distort capital allocation, this approach goes in the opposite direction.”

**E. Costs and Burdens of Implementation.**

As discussed in our letter dated September 17, 2013, Federated estimates that the initial nationwide costs of implementing Alternative One (such as the costs of changing investment policies, upgrading systems, new training, etc.) would be in the range of at least \$4 billion to \$7 billion. It would also entail 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 (including compliance costs, systems maintenance and updating, among other costs). In contrast, Federated estimates that the estimated costs of Alternative Two would be much lower. Commenters who addressed these matters uniformly agreed.

- **Treasury Strategies:** Reports submitted by Treasury Strategies provided estimates as to the costs of implementing a floating NAV for investors, broker-dealers, fiduciaries, fund complexes and others.<sup>86</sup> Treasury Strategies estimated that:
  - “[T]otal 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).” These estimates did not include opportunity costs related to lower returns and higher borrowing costs.<sup>87</sup>
  - Fiduciaries will each likely have to expend between \$400,000 and \$425,000.<sup>88</sup>
  - “Trust departments using third-party sweep software would depend on their system vendors for sweep enhancement. . . . Costs would be at least \$2 to \$3 million per vendor, possibly more, once all new requirements have been scoped.”<sup>89</sup>

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<sup>86</sup> Chamber-CCMC/TSI, TSI.

<sup>87</sup> Chamber-CCMC/TSI.

<sup>88</sup> *Id.*

<sup>89</sup> TSI.

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- MMF Portals will each likely have to expend between \$500,000 and \$600,000. Costs for individual broker-dealers will depend heavily on size.<sup>90</sup>
- [F]or large broker-dealers and bank capital markets groups, one-time costs will be between \$3 million and \$3.5 million.<sup>91</sup>
- For large transfer agents, upgrades, training and related expenses would cost approximately \$2 to \$2.5 million.<sup>92</sup>
- 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.” Ongoing costs related to necessary staff expansion would be an additional \$10 to \$12.5 million per year.<sup>93</sup>
- **Government Investment Officers Association:** “GIOA Members directly manage cash balances of governmental units. Collectively, we manage billions of dollars that are invested until disbursed by state and local government entities. As public-sector asset managers, the floating NAV proposal will potentially:
  - Increase costs associated with the accounting required to track slight changes in NAV pricing – potentially in only the 4th decimal; . . .
  - Increase costs due to the required change over in internal systems which are geared for an asset type of \$1.00 NAV funds. Internal system changes will need to add average cost methodologies and date and time tracking for intra-day NAV resets;
  - Increase costs due to accounting rule selections regarding average cost or other elective methodologies for valuing MMF positions;

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<sup>90</sup> Chamber-CCMC/TSI.

<sup>91</sup> TSI.

<sup>92</sup> Chamber-CCMC/TSI.

<sup>93</sup> *Id.*



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- Increase costs of personnel and staff in regards to the added time required to reconcile MMF positions and costs . . . .”
- **Dechert:** “The Proposing Release states that money funds that have both institutional and retail share classes (or both institutional and retail shareholders in a single class of shares) would need to reorganize into separate money funds – a retail money fund and an institutional money fund – in order to rely on the retail money fund exemption under Alternative 1. The Proposing Release further discusses the costs associated with such a reorganization, including the costs that would be necessary to prepare appropriate organizational documents and costs incurred by the fund’s board of directors to approve such documents. However, the Proposing Release does not discuss the potential costs of obtaining shareholder approval to the extent that a money fund’s charter documents and/or applicable state law would require shareholder approval to effect a reorganization. . . . We therefore urge the Commission to provide guidance with respect to the mechanics of reorganizing a money fund that has both institutional and retail share classes (or both institutional and retail shareholders in a single class of shares) into separate money funds and, if necessary, provide exemptive relief from Section 18 of the 1940 Act to allow these types of reorganizations. We also suggest that the Commission seek guidance from the Internal Revenue Service (“IRS”) regarding the tax consequences of these types of reorganizations.”
- **Dreyfus:** “Total costs and man-hours to modify systems, controls, and procedures to accommodate a VNAV structure on an industry-wide basis (including sponsors, distributors, and service providers) will be enormous. We have identified and listed below some of the operational burdens we believe will be borne by various MMF providers related to the VNAV Proposal:

Fund Accounting and Administration.

- Implementation of controls and procedures to support daily valuation of portfolio securities for all (if amortized cost no longer is permitted) or some types of MMFs.
- Program modifications necessary to receive prices from pricing vendors one or more times each business day.

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- Program modifications necessary to calculate the four-digit VNAV while incorporating the traditional servicing aspects of MMF such as 2a-7 compliance (e.g., WAM and WAL calculations).
- Modification of existing controls and procedures to support the four-digit VNAV.
- Program modifications necessary to calculate the fund's yield based on a four-digit VNAV.
- Additional tracking of information for tax reporting including portfolio gain/loss information and wash sale monitoring.
- Program modifications necessary to communicate four-digit VNAVs and other fund data to intermediaries, web sites, data providers, etc.
- Modifications to workflows to accommodate new settlement times in a VNAV environment.

Transfer Agency/Custody.

- Address shift in “same-day liquidity” to delivering payments post-end of day pricing; will result in significant change in the sweep mechanisms for client cash in particular (if undertaken).
  - Address need for increased controls with respect to late-day wires and T+1 settlement in a VNAV environment.
  - Certain systems will have to be modified to accept and use a four decimal place NAV.
  - Not all relevant systems currently possess this capability.
  - Would need to track gains and losses at the subscription/redemption level. Enhanced recordkeeping and forms creation relating to gains and losses of purchase and redemption activity previously not required for CNAV MMFs.”
- **Chapin Davis:** “The accounting and recordkeeping systems that we use to process these transfers and payments are highly automated, and link together with automated systems of banks and the MMFs' transfer agents. It would be very expensive (and potentially not

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economically viable) to rebuild our automated systems to process these transfers and payments at other than \$1/share.”

- **UBS:** “While the benefits to be derived from Alternative 1 are somewhat speculative, Alternative 1 would impose significantly higher costs on money fund shareholders. Requiring the reorganization of money funds into separate ‘retail’ and ‘institutional’ money funds would be extremely expensive. In addition, the conversion of an institutional money fund from a stable to a floating NAV would require cost-prohibitive operational changes that would likely cause many sponsors to exit the business, reducing competition and efficiency in the marketplace. Converting to a floating NAV presents settlement issues, as floating NAV money funds may no longer be able to pay redemptions on a same day or intraday basis. Alternative 1 would require costly systems changes and would reduce the appeal to many investors, including corporate treasurers that value very highly the same day settlement feature. Finally, floating NAV money funds would not be offered on sweep programs operated by broker-dealers.”
- **Fidelity:** “We estimate the costs of implementing the liquidity fees and gates proposal will be approximately \$11 million, which exceeds the SEC’s estimates. These are largely one-time costs for the necessary systems and public disclosure modifications.”
- **PFM Group:** “For the purposes of quantifying these additional costs, PFMAM undertook an initial analysis of the potential impact of the proposal and discovered significant one-time and ongoing increases for the Fund and its Administrator (e.g., changes to accommodate cash management services), the Investment Advisor (e.g., pricing vendor expenses and costs related to increased staffing to manage valuation complications and uncertainties), and for the Transfer Agent (e.g., updates necessary to systems/applications).”
- **Wells Fargo:** “The estimates in the Release regarding the costs of a variable NAV to institutional money market fund shareholders further demonstrate why many of them would abandon prime money market funds. The Release correctly points out that, in response to a variable NAV requirement, many institutional shareholders will require modifications to systems and related procedures and controls . . . . The Release breaks these shareholders into two groups: (i) those that would require less extensive and labor-intensive modifications, and (ii) those that would require more extensive and labor-intensive modifications. Among the former group, the Release estimates that each shareholder will incur one-time costs ranging from \$123,000 to \$253,000. Among the latter group, the Release estimates one-time costs ranging from \$1.4 million to \$2.9

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million per shareholder. These costs may not appear substantial at first glance, but when viewed in the context of current money market fund returns, they will provide a tremendous disincentive to continued investment in prime institutional money market funds. To provide an example, we will assume that an institutional shareholder with \$10,000,000 invested in prime money market funds requires the minimum in systems modifications and incurs the minimum estimated one-time costs— \$123,000. We will further assume that the shareholder earns 0.04% annually from its investments in prime money market funds—0.04% being the average prime money market fund annual return in 2012. Under these assumptions, the lowest estimated one-time costs would represent more than thirty years of returns for such a shareholder.”

- **SunTrust:** “Our Consultant estimates that, unless our existing service providers can absorb these functions, the new systems and services which will be required to enable SunTrust to provide tax basis reporting and four decimal pricing with respect to its customers' money market fund shares will force SunTrust to spend over \$10,000,000 in initial startup costs and will thereafter increase our annual cost of operations by \$1,000,000 to \$2,000,000. Furthermore, even if this function can be provided by our existing service providers, our Consultant informs us that our contracts with them may allow the service providers to pass on to SunTrust (and we assume other Intermediaries) any similar costs which the service providers may incur as a result of the new tax basis reporting and four decimal pricing requirements. Our Consultant estimates that such pass through charges could be as high as \$5,000,000. . . .

Our customer statements are currently generated by a third party. It is anticipated that the new tax basis reporting changes will require programming and man-hour costs. Additionally, merely the cost of paper to print the reports and postage to mail the reports will increase significantly. Currently SunTrust creates 44,000 statements per month at an annual cost including printing and postage of \$560,000. If Alternative 1 is adopted, our Consultant estimates that the new tax basis requirement will increase our statement preparation expenses by 10-15 percent or \$50,000 to \$75,000.”

- **DST:** “The aggregated one-time cost estimate for updating our transfer agency shareholder record keeping system is estimated to be \$9,450,000. It is important to consider that our shareholder recordkeeping platform is one of many in the industry that provide servicing to the end shareholder, particularly when factoring in intermediaries.”
- **American Bankers Association:** “Bank trust departments use specialized accounting systems, including those that are specific to trust accounts, to manage payments and

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distributions for client accounts that must comport with state and federal laws governing fiduciary accounts. The bank's systems, in turn, interface with the systems of other entities that provide services for client accounts. If a bank were to choose to invest fiduciary cash awaiting investment in an MMF with a floating NAV, those systems would have to be redesigned at significant cost. Such costs, along with costs to monitor compliance with wash sales and accounting issues would disincent investments in FNAV MMFs by bank fiduciaries." (citations omitted).

- **SIFMA:** Based on responses by 28 respondents (10 asset managers and 18 distributor/intermediaries) to a survey on the operational impact of MMF reform, SIFMA reported that, in order to modify procedures, controls and systems associated with implementing the floating NAV:
  - 40% of respondents estimated total initial costs of \$2 million to \$5 million;
  - 12% of respondents estimated total initial costs of \$5 million to \$10 million;
  - 8% of respondents estimated total initial costs of \$10 million to \$15 million; and
  - 12% of respondents estimated that total initial costs would exceed \$15 million.

SIFMA further reported that as to the floating NAV proposal, "[o]ngoing annual costs are estimated as 10% to 15% of the initial cost by 28% of respondents, 15% to 20% by 4% of respondents and at over 20% of initial cost by 20% of respondents. Based on respondents' estimated initial costs, these ongoing costs mean that 52% of respondents estimate ongoing annual costs of \$200,000 or more, with about half of those respondents estimating ongoing annual costs over \$500,000."

- SIFMA's survey also revealed that respondents believed Alternative Two would be expensive to implement. SIFMA reported that, in order to modify procedures, controls and systems associated with the liquidity fee:
  - 24% of respondents estimated total initial costs of \$2 million to \$5 million;
  - 8% of respondents estimated total initial costs of \$5 million to \$10 million;
  - 4% of respondents estimated total initial costs of \$10 million to \$15 million; and

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SIFMA further reported that “[f]or all survey respondents in the aggregate, ongoing annual costs of implementing the liquidity fee were estimated as 10% to 15% of initial costs for 17% of respondents, 15% to 20% of initial costs by 12% of respondents and 20+% of initial costs by 8% of respondents.”

- SIFMA reported that, in order to modify procedures, controls and systems associated with the temporary redemption gate:
  - 17% of respondents estimated total initial costs of \$2 million to \$5 million;
  - 8% of respondents estimated total initial costs of \$5 million to \$10 million; and
  - 17% of respondents estimated total initial costs of \$1 million to \$2 million.

SIFMA further reported that “[o]ngoing annual costs are estimated as 10% to 20% of initial cost by 33% of Survey respondents.”

- **State Street:** “State Street believes significant enhancements of core fund accounting systems would be required and additional staffing would be needed to price floating NAV funds. Those costs would increase exponentially if we were to provide pricing multiple times a day for floating NAV funds. We agree with the staff that impacted entities would likely have to perform an in-depth analysis of the proposed rules to calculate the costs of modifications required for their systems. State Street believes the one-time costs of implementation for affected entities would be extremely high. Downstream systems, such as financial reporting, compliance and tax systems, would also be impacted and an in-depth analysis would be required to determine the additional costs of modifying those systems. . . . State Street believes liquidity fees and gates would require minimal enhancements to our core custody/fund accounting system with minimal costs. Most systems enhancements would be required with respect to transfer agents’ and intermediaries’ systems. It is expected that while these systems include basic functionality to accommodate liquidity fees and gates, enhancements may be required to accommodate the specific requirements of the new rules.”

## VI. Additional Economic Analysis

While the major part of this letter demonstrates the range of views of commenters on various aspects of the Commission’s proposals, this section identifies a number of questions for

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further review. By law, the Commission must examine how its proposals would affect the economy, including whether they would impede or promote efficiency, discourage or encourage competition, or raise or lower the cost of capital for businesses and other entities that provide jobs for millions of Americans. Although the comment period was too short to fully cost out the proposals and assess their full economic impact, Federated and others have provided substantial amounts of data for the Commission's review. Still, Federated has continued to review the proposals and has identified the following additional matters that the Commission, in light of its legal obligation to consider economic impacts, must assess before taking action on the proposals.

**A. Sources of Systemic Risk and Appropriate Regulation.**

To date, reform efforts in the wake of the financial crisis have treated all non-government issuers alike vis-à-vis systemic risk. But the extensive analysis of Carmen Reinhart and Kenneth Rogoff demonstrates that the roots of past crises, including that of 2007-2008, lie in rapid asset or commodity price deflation that impairs the debt of financial institutions.<sup>94</sup> Similarly, Federal Reserve Chairman-nominee Janet Yellen has underscored that “[t]o understand what went wrong” in the U.S. economic system, one should refer to “Hyman Minsky’s path-breaking work on speculative financial booms and busts.”<sup>95</sup> Minsky’s “Financial Instability Hypothesis” characterizes the increasing systemic risk associated with the growth of highly leveraged firms that are unable to meet interest obligations through stable cash flows, but depend, for instance, on rolling over short debt to remain solvent.<sup>96</sup> Consistent with the conclusions of Reinhart and Rogoff, Minsky describes the role of leveraged financial institutions, or “speculative finance units,” in financial crises. He suggests that “over a protracted period of good times” these financial entities grow in size and significance to become epicenters of the eventual crises.<sup>97</sup>

Nonfinancial corporate or municipal issuers base their ability to repay their debts on cash flows from operating businesses. They do not depend on the ability to roll over large volumes of short term debt. By contrast, financial issuers are large, highly leveraged companies, that tend to

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<sup>94</sup> Carmen M. Reinhart and Kenneth Rogoff, *This Time is Different: Eight Centuries of Financial Folly*, Princeton University Press, 2009.

<sup>95</sup> Janet Yellen, *Macropprudential Supervision and Monetary Policy in the Post-crisis World*, 46 Business Economics 1, 3-12 (2011).

<sup>96</sup> Hyman Minsky, *The Financial Instability Hypothesis*, Working Paper No. 74, The Jerome Levy Economics Institute of Bard College (May 1992), <http://www.LevyInstitute.org/pubs/wp74.pdf>.

<sup>97</sup> *Id.*

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collateralize debt with financial assets. Crises arise when these leveraged financial entities and their asset portfolios are subject to rapid revaluation. Yet, the Commission's MMF proposals, by applying to all prime and tax-exempt funds, would effectively lump nonfinancial corporate prime and municipal issuers in with the financial issuers that are the actual source of risk. This amounts to a penalty on other sectors that should otherwise be borne by financial issuers.

If regulators wish to protect bank stability via the wholesale funding markets, then the simplest way of doing so is to limit bank reliance on short-term financing directly, rather than by regulating the capital markets and MMFs. The Federal Reserve and banking agencies have recently proposed the Liquidity Coverage Rule (LCR), which is designed to mitigate the risks associated with bank reliance on unstable wholesale funding.<sup>98</sup> In proposing this rule, the Federal Reserve has recognized that the systemic risk that FSOC has identified regarding wholesale funding rests primarily within the banking sector. It is inappropriate for the Federal Reserve to pursue, or for the Commission to propose, additional extraordinary regulation of mutual funds or the capital markets when the concerns lie within the banking sector and can be addressed through bank regulation. The Commission must thoroughly evaluate the role that the LCR will play in mitigating the primary risk that additional MMF regulation was meant to achieve.<sup>99</sup>

## **B. Effects of Crowding Out.**

Commenters and the Release agree that the proposals would drive assets out of prime MMFs and into government funds. They also agree that this would reduce returns for investors and increase costs for issuers – factors that are directly linked to capital formation. But at a

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<sup>98</sup> *Liquidity Coverage Ratio: Liquidity Risk Measurement, Standards, and Monitoring*, \_\_ Fed. Reg. \_\_ (Oct. 24, 2013).

<sup>99</sup> State Street also has commented on how multiple reform initiatives that relate to short-term cash management are now pending both in the United States and elsewhere. The Commission must consider how the combination of these initiatives will affect MMFs and their investors: “We are also concerned by [the] potential negative combined impact of several emerging global regulatory initiatives on cash management alternatives for our institutional investor client base. First, the Commission’s pending money market fund proposal (and similar proposals elsewhere, such as the European Union) will make registered money market funds unworkable for some subsets of institutional investors. Second, global regulatory focus on repos and other securities financing transactions as part of “shadow banking” initiatives could further limit options for short-term investment of cash. Third, pending proposals to increase the leverage ratio will limit the ability of banks to accept large cash deposits on their balance sheets. We are concerned that regulators have not fully considered the combined impact these initiatives could have on the ability of institutional investors to manage cash.”



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deeper level, the Commission must also consider how what is projected to be a dramatic growth of government funds at the expense of prime funds and private issuers will yield a “crowding out” effect in the short-term financing market.

In cases of “crowding out,” increased federal borrowing, often during periods of deficit spending, leads to higher borrowing rates for private sector issuers that must compete with the government. Thus, as federal borrowing increases, there will be fewer dollars available for investment in privately issued instruments. The effects of this trend would extend not only into the commercial paper markets where MMFs operate, but into other debt markets, utilized by private companies to finance investment and growth. For example, the proposal may lead to a general impairment in structured credit intermediation and a diminished asset-backed securities market. Asset-backed securities, which support auto lending, home lending and other consumer borrowing, are structured into various classes, each with different maturities, payment schedules, and risk levels. In this fashion, they can attract more investors by offering customized exposures to credit risk. Commercial paper (with its short maturity, abbreviated payment schedule and lower risk) is a common feature in asset-backed pools. In a market that experiences “crowding out” of commercial paper, sales of asset-backed pools will not be able to realize their full economic values, causing a slowdown in securitizations, and slowing economic growth. While the Release briefly acknowledges that MMFs hold asset-backed securities, it does not examine how the proposal would affect initial sales of asset-backed securities.

### **C. Impact on the Yield Curve.**

The Commission’s proposals would cause investors to shift assets from prime MMFs to government MMFs, or even to invest directly in government securities. Therefore, it is highly likely that yields on short-term government securities will fall, possibly becoming negative. This would have adverse consequences not only for business users of MMFs but also for millions of individual savers or those on fixed incomes who could then be forced into riskier assets in order to replace investment income. These dynamics may even hamper the Treasury Department’s ability to manage its debt maturity structure as investors become more reliant upon government MMFs. There would be dislocations and discontinuities in private sector issuer curves and unknown consequences from the loss of private issuers in defining the effective overnight rate used in portfolio and financing decisions across the markets. The capital markets would be generally weakened, with fewer deep venues for absorbing senior debt issues or tranches.

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Finally, the normal marketplace for corporate notes and bonds with maturities of under one year would be disrupted.<sup>100</sup>

**D. Effects on Bridge Financing.**

Commercial paper is frequently used as a form of bridge financing. For example, while a corporation may believe that interest rates will fall in the future, it may decide that it should not wait to finance a new project, but should pursue it immediately. In this situation, the corporation may arrange to issue commercial paper until longer term bonds or other securities are sold. State and municipal entities also issue short-term debt in similar situations. The ability to obtain bridge financing in this form depends on a deep and liquid commercial paper market. The Commission's release has acknowledged that MMFs are likely to lose investors if its proposals are adopted. If MMFs, especially prime MMFs, become smaller, then the markets will necessarily become less liquid, less competitive, and more costly for issuers. Yet, the Commission has not considered how these likely outcomes would affect the use of the commercial paper markets to locate bridge financing.

**E. Adverse Impact On Market Behavior.**

The Commission has not availed itself of the extensive body of thought and literature on market microstructure in assessing the impact of a floating NAV.<sup>101</sup> In particular, the Commission has not adequately considered how a floating NAV may affect investor behavior. Economic modeling shows that a floating NAV would increase, and not reduce, preemptive redemptions by investors that use simple signals (not credit analysis) to judge and react to risk. Nor has the Commission considered how advisors' efforts to manage a floating NAV could transform the short-term private debt market in a manner completely opposed to that which regulators are seeking. In particular, MMFs have historically been largely buy-and-hold portfolios. De minimis variations in security prices that do not reflect the true credit worthiness of the borrower are monitored by the advisor but do not cause accounting gains and losses, or become self-fulfilling, because advisors do not trade on these small fluctuations. Under amortized cost, the advisor therefore has no incentive to realize losses associated with small variations in price, provided that the security continues to represent minimal credit risk.

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<sup>100</sup> See also Invesco at 17-18 (noting possibility of negative yields in secondary government securities markets, especially after implementation of Liquidity Coverage Ratio and Derivative Margining Requirements).

<sup>101</sup> See, e.g., R.E. Bailey, *Economics of Financial Markets*, Cambridge University Press (2005); Peter D. Spencer, *The Structure and Regulation of Financial Markets*, Oxford University Press (2000).

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However under a floating NAV, there is no such inhibition, and the effect of a floating NAV may cause MMFs to revert from a buy-and-hold market to more of a traded market.

**F. A Game-Theoretic Formulation of Investor Behavior and Alternative Two.**

As part of its evaluation of market microstructure, the Commission must specifically consider the effect of proposed reforms on the so-called “first mover advantage” and its relationship to mutual funds, and MMFs in particular. This theoretical construct has been central to FSOC’s belief that MMFs possess systemic risk, representing a key finding in its Proposed Recommendations.<sup>102</sup> In their September 12, 2013 comment letter, the twelve regional Federal Reserve Bank presidents state that Alternative Two would not “meaningfully address the risks to financial stability posed by MMMFs,” without any evaluation of how a Fee/Gate model might be designed to mitigate run risk. The recent Office of Financial Research (“OFR”) Report on the Asset Management industry concludes that a first mover advantage remains even after a floating NAV is imposed.<sup>103</sup>

Taking these arguments at face value, it is apparent that FSOC, the Federal Reserve and the OFR see first mover risk behind every corner, and use the term in a loose and subjective way. In light of this highly conjectural approach, rulemaking that indiscriminately relies on this concept, without any attempt at measurement or precise meaning, is arbitrary and capricious. It is therefore imperative that the SEC use its substantial analytic resources to evaluate whether and how such effects exist, or can reduced or mitigated. This would logically contain, among other things, a rigorous game theory formulation of investor behavior to evaluate how risks may be addressed through a proper formulation of Alternative Two.

**G. The Impact on Efficiency.**

Rule 2a-7 has facilitated securities-based intermediation of borrowing and lending that has enabled extraordinary efficiency gains. In a normal interest rate environment, MMFs offer higher returns to investors and lower borrowing costs for issuers of short-term debt. The average gross fees charged by MMFs (the difference between gross portfolio yields and the net yield

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<sup>102</sup> In its Proposed Recommendations the FSOC stated that: “Together, these activities and practices foster MMFs structural vulnerability to runs by creating a first-mover advantage that provides an incentive for investors to redeem their shares at the first indication of any perceived threat to an MMF’s value or liquidity.”

<sup>103</sup> *Asset Management and Financial Stability* at 12-16, 19-20 (Sept. 2013)  
<http://www.treasury.gov/initiatives/ofr/research/Pages/AssetManagementFinancialStability.aspx>.

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received by shareholders) is normally less than 20% of the corresponding spread earned by banks. The lower returns to investors and the significant increase in borrowing costs for issuers caused by a less robust MMF industry would represent a systematic and certain “give-back” of these efficiency gains that the Commission must assess as part of any new rulemaking. These certain systemic losses must also be assessed in relation to the speculative and negligible social risks that MMFs might still contain after a proper implementation of Alternative Two that gives boards full latitude in protecting shareholders. To begin an examination of the resulting loss of efficiency, regulators could look to the 1970s and prior years. As described in a Treasury Department report from 1991, depository institutions at that time were “protected from both product and geographic competition; their funding costs were controlled and profitability enhanced because of deposit interest rate ceilings and ready access to the funds of savers; and the federal safety net provided by deposit insurance and other mechanisms added greatly to the value of the banking franchise.” The value of a banking franchise may indeed increase in such an environment, but the benefit would be reserved to the bank’s shareholders and would flow from lost competition and efficiency.

In addition, the floating NAV devalues credit research by investment advisers, and forces investors to spend time and resources in monitoring floating NAVs and underlying issuer credit strength. The Commission has not quantified the likely costs and extent of the time and efforts that investors would face in doing so.

#### **H. The Impact on Competition.**

The money market industry is characterized by significant competition among many strong firms, with high operational effectiveness and high client satisfaction, all while fees have steadily declined. The proposed reforms will likely arrest or reverse these trends for tax-exempt and prime institutional MMFs by causing less profitability and greater consolidation in the fund industry. This will lead to higher fees as asset volumes decline. Banks, to a large extent, have already exited the market for short term loans, even to the highest quality issuers. Rising regulatory, capital and other costs that banks face pursuant to other regulatory reforms will also prevent them from serving the current lending function of MMFs except at much higher rates. The Release contains a bullet point with some questions relating to this point,<sup>104</sup> but merely raising questions, without the analysis that the Commission is able to perform, does not meet the legal obligation to consider the consequences of proposals on efficiency, competition and capital formation.

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<sup>104</sup> Release at 36923.

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**List of Commenters and Abbreviations as of November 21, 2013**

- **1,223 commenters** classified by the Commission as “form” letters. Despite the Commission’s characterization of these letters as “form” letters, and the fact that the Commission’s comment file does not list the names of these commenters, we have reviewed the list and observe that these 1,223 letters are the comments and opinions of individuals and business executives from a range of industries, including banks, trust companies, broker dealers, investment advisers, and corporations throughout the United States, as well as state and local government officials, all of whom have a stake in the continued utility of MMFs as an investment and cash management product;
- **42 Members of Congress who are former state and local government officials** (“42 Members of Congress”);
- **AICPA**, the world’s largest member association representing the accounting profession, with more than 394,000 members in 128 countries;
- **Airgas, Inc., Alert Stamping & Manufacturing Co., Inc., Allegheny Technologies Incorporated, Alydar Agency, Inc., Associated Industries of Florida, Association for Financial Professionals, Association of Commerce & Industry of New Mexico, Blyth, Inc., Brandywine Communications, Chicagoland Chamber of Commerce, Cincinnati USA Regional Chamber, Cross Diamond Electric, Cruise Control Auto Care, Dallas Regional Chamber, Devon Energy Corporation, Dominion Resources Inc., Downey-Goodlein Elevator Corp., Earl's Lawn Care, East Tennessee Section of AACE International, Elite Marketing, Elite Securities, Inc., Engineered Systems Inc., Financial Executives International, Florida Chamber of Commerce, FMC Corporation, Fort Worth Chamber of Commerce, Global Tooling Solutions, LLC, Great Plains Energy, Inc., Greater Boston Chamber of Commerce, Greater Durham Chamber of Commerce, Greater Irving-Las Colinas Chamber of Commerce, Greater Pittsburgh Chamber of Commerce, Greater Providence Chamber of Commerce, Greater Raleigh Chamber of Commerce, Greater Springfield Chamber of Commerce, HCA, Indiana Chamber of Commerce, Integrated Science Solutions, Inc., Joyco MultiMedia, LLC, Kentucky Chamber of Commerce, National Association of Corporate Treasurers, Navistar, New Jersey State Chamber of Commerce, Nissan North America, Inc., Noble Energy, Inc., Outdoor Amusement Business Association, Inc., Pharmacy Solutions, Regal Marketing Inc, Retail Industry Leaders Association (RILA), Ruan, Safeway Inc., South Baldwin Chamber of Commerce, Telephone and Data Systems, Inc., Texas Association of Business, The Boeing Company, Time Warner, U.S. Chamber of Commerce, Vulcan Materials Company** (“U.S. Chamber and Business Joint Letter”);

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- **Aleph Investments, LLC;**
- **American Bankers Association, Center of Securities Trusts & Investments,** representing over 95 percent of the banking industry's \$13 trillion in assets ("American Bankers Association");
- **American Benefits Council,** an organization whose members sponsor directly or provide services to retirement, health and compensation plans covering more than 100 million Americans and millions of others internationally;
- **American Council of Life Insurers,** a national trade association with 300 members that represent more than 90 percent of the assets and premiums of the life insurance and annuity industry ("ACLI");
- **Americans for Financial Reform,** a coalition of more than 250 national, state and local consumer, civil rights, investor, retiree, community, labor, faith based and business groups;
- **Arnold & Porter LLP;**
- **Artie Green, CFP;**
- **Association for Financial Professionals, Financial Executives International's Committee on Corporate Treasury, National Association of Corporate Treasurers, National Association of Manufacturers, National Retail Federation, Retail Industry Leaders Association, and U.S. Chamber of Commerce;**
- **Association for Financial Professionals;**
- **Axiom SL;**
- **Better Markets, Inc.;**
- **BlackRock, Inc., Fidelity Investments, Invesco Ltd., Legg Mason & Co, LLC and Western Asset Management Company, Northern Trust Corporation, T. Rowe Price Associates, Inc., Vanguard and Wells Fargo Funds Management, LLC** ("Joint Fund Sponsors");
- **BlackRock;**
- **The Boeing Company** ("Boeing");
- **Brian Smith;**
- **California Association of County Treasurers and Tax Collectors,** representing the treasurers and tax collectors in the 58 counties throughout California with associate memberships for financial service firms;
- **Capital Advisors Group;**
- **Cathy Santoro** ("Santoro");

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- **Center for Capital Markets Competitiveness, U.S. Chamber of Commerce**, the world's largest business federation, representing more than three million businesses and organizations of every size, sector and region ("Chamber-CCMC");
- **CFA Institute**, a global, not-for-profit professional association of more than 122,600 investment analysts, advisers, portfolio managers, and other investment professionals in 142 countries;
- **Chapin Davis Inc.** ("Chapin Davis");
- **Charles Schwab Investment Management** ("Schwab");
- **Chemung Canal Trust Company**;
- **Chief Financial Officer, State of Florida** ("Florida CFO");
- **Chris Barnard** ("Barnard");
- **Cleco Corporation**;
- **Coalition of Mutual Fund Investors**;
- **Committee on Capital Markets Regulation**, thirty-two individuals drawn from the finance, investment, business, law, accounting, and academic communities chaired jointly by R. Glenn Hubbard (Dean, Columbia Business School) and John L. Thornton (Chairman, The Brookings Institution) and directed by Hal S. Scott (Harvard Law School);
- **Committee on Investment Management Regulation, New York City Bar**, a voluntary association of lawyers and law students with over 24,000 members ("NYC Bar");
- **The County of San Diego Treasurer Tax Collector** ("San Diego Treasurer");
- **Craig Adamson**;
- **Crane Data**;
- **Cumberland Valley National Bank & Trust**;
- **Darren Bramen**;
- **Davenport & Company LLC** ("Davenport");
- **Dechert LLP** ("Dechert");
- **Defined Contribution Institutional Investment Association**, a non-profit association dedicated to enhancing the retirement security of American workers by promoting better defined contribution plan design and institutional investment management approaches (DCIIA);
- **Deloitte & Touche LLP**;
- **Deutsche Investment Management Americas Inc.** ("Deutsche");
- **Deval L. Patrick, Governor, Commonwealth of Massachusetts** ("Governor Deval Patrick");
- **Drew B. Winters, Texas Tech University** ("Texas Tech");



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- **Dorothy B. Sherry;**
- **The Dreyfus Corporation** (“Dreyfus”);
- **DST Systems, Inc.** (“DST”);
- **Edward Jones;**
- **Edward P. Cernocky;**
- **Ernst & Young LLP;**
- **Farmers Trust Company;**
- **Federal Regulation of Securities Committee, American Bar Association**, a voluntary professional organization, with nearly 400,000 members and more than 3,500 entities (“American Bar Association”);
- **Federal Reserve Bank of Boston, et al.** (“Federal Reserve Banks”);
- **Federated Investors, Inc.** (“Federated Investors”);
- **The Fidelity Fixed-Income and Asset Allocation Funds;**
- **Financial Information Forum**, formed in 1996 to provide a centralized source of information on the implementation issues that impact the financial technology industry across the order lifecycle with participants including trading and back office service bureaus, broker-dealers, market data vendors and exchanges;
- **Financial Services Institute** (“FSI”);
- **The Financial Services Roundtable** (“Financial Services Roundtable”);
- **FMR Co., Fidelity Investments** (“Fidelity”);
- **Futures Industry Association**, a trade organization for the futures, options and over-the-counter cleared derivatives markets with membership including the world’s largest derivatives clearing firms as well as leading derivatives exchanges from more than 20 countries;
- **General Treasurer, State of Rhode Island** (“Rhode Island Treasurer”);
- **George Blumel;**
- **Goldman Sachs Mutual Funds and Goldman Sachs Asset Management** (“Goldman”);
- **Government Finance Officers Association**, a professional association of state, provincial and local finance officers in the United States and Canada with more than 17,000 members;
- **Government Finance Officers Association, International City/County Management Association, National Association of State Auditors, Comptrollers and Treasurers, National Association of State Treasurers, National Association of Counties, U.S. Conference of Mayors, National League of Cities, American Public Power Association, Council of Infrastructure Financing Authorities, National Association**



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**of Health and Educational Facilities Finance Authorities, Airports Council International – North America, and Large Public Power Council** (“Government Finance Officers Association and Public Sector Signatories”);

- **Government Investment Officers Association**, representing government investment officers across the United States, et al. (“Government Investment Officers Association and State Treasurer Signatories”);
- **The Greater Durham Chamber of Commerce**, representing more than 800 businesses within the county of Durham, NC (“Greater Durham Chamber”);
- **Greater Pittsburgh Chamber of Commerce** (“Greater Pittsburgh”);
- **Harry Kluger**;
- **Hefren-Tillotson, Inc.**;
- **Helen Pantazakos**;
- **Home Federal Bank of Tennessee**;
- **HSBC Global Asset Management** (“HSBC”);
- **iMoneyNet**;
- **Independent Directors Council**;
- **Independent Trustees of the Federated Funds** (“Independent Trustees/Federated Funds”);
- **Independent Trustees of The North Carolina Capital Management Trust** (“Independent Trustees/North Carolina Capital Management Trust”);
- **The Institute of Public Investment Management** (“IPIM”);
- **Institutional Cash Distributors, LLC**;
- **Interactive Data Pricing and Reference Data** (“Interactive Data”);
- **Invesco Ltd.** (“Invesco”);
- **Investment Company Institute**, an organization whose members manage total assets of \$15.4 trillion and serve more than 90 million shareholders (“ICI”);
- **Ira M. Shapiro, L.L.C.**;
- **J. Huston McCulloch, Professor Emeritus, Economics and Finance, Ohio State University** (“McCulloch”);
- **J.P. Morgan Investment Management Inc.** (“J.P. Morgan”);
- **James J. Angel, Ph.D., CFA, Visiting Associate Professor, The Wharton School, University of Pennsylvania** (“Angel Research Paper”);
- **Jane Augustus**;
- **Jeffrey Gordon, Columbia Law School**;
- **John Chang** (“Chang”);
- **John Friedrich**;

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- **John Sklar;**
- **Joseph Ratto;**
- **Kentucky Chamber of Commerce**, with 2,000 member companies across the state representing over half of Kentucky's private sector workforce (“Kentucky Chamber”);
- **KeyBank, NA** (“KeyBank”);
- **KPMG LLP;**
- **Laird Hepburn;**
- **Large Public Power Council**, comprised of 26 of the nation's largest public power systems (“LPPC”);
- **Lawrence S. York;**
- **Legg Mason and Co., LLC and Western Asset Management Company** (“Legg Mason”);
- **Lincoln D. Chafee, Governor, State of Rhode Island** (“R.I. Governor Lincoln Chafee”);
- **Linda Pearson Vieser;**
- **Lyons & Bolek LLP;**
- **M&T Bank Corporation** (“M&T Bank”);
- **MainSource Bank;**
- **Maneesh Pangasa;**
- **Margaret Wood Hassan, Governor of New Hampshire** (“N.H. Governor Margaret Wood Hassan”);
- **Mark Dempsey;**
- **Massachusetts Municipal Association**, representing the 351 cities and towns of the Commonwealth of Massachusetts;
- **Mayor Beth Van Duyne, Mayor Betsy Price, Mayor Greg Fischer, Mayor Greg Fischer, Mayor John Dickert, Mayor Mark Mallory, Mayor Nancy McFarlane, Mayor Ralph Becker, Mayor Robert N. Cluck, M.D., Mayor Scott Smith, Mayor Sherry Carran, Mayor Stephanie Rawlings-Blake, Metropolitan Mayors Caucus** (“Metropolitan Mayors Caucus and Signatories”);
- **Mayor, Brockton, Massachusetts;**
- **Mayor, City of Rancho Cordova, California;**
- **Mayor, Quincy, Massachusetts;**
- **Mayor and City Council of Cincinnati** (“Cincinnati”);
- **Melanie L. Fein, Fein Law Offices** (“Fein”);
- **Mercatus Center at George Mason University** (“George Mason Mercatus Center”);
- **Michael Gauding;**

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- **Michael K. Karry** (“Karry”);
- **Milton Ryalls**;
- **MSCI Inc.**;
- **Mutual Fund Directors Forum**;
- **Myra Page**;
- **Myrna L. Grigsby** (“Grigsby”);
- **Nadine Refsell**;
- **National Association of College and University Business Officers**, a membership organization representing more than 2,500 colleges, universities, and higher education service providers across the country and around the world;
- **National Association of State Auditors, Comptrollers and Treasurers**, an organization of state officials who are responsible for the financial management of state government (“NASACT”);
- **National League of Cities**, an advocate for the more than 19,000 cities, villages and towns;
- **New Hampshire College & University Council**, a non-profit consortium of 22, public and private institutions of higher education in the state of New Hampshire (“NHCUC”);
- **New Hampshire State Treasurer** (“New Hampshire Treasurer”);
- **New Jersey League of Municipalities**, representing all 565 municipalities in New Jersey;
- **New Jersey State Chamber of Commerce**, an organization whose member companies provide jobs for over a million people in New Jersey (“New Jersey Chamber”);
- **New York State Association of Counties**, an advocate for 62 counties, including the City of New York;
- **North Carolina Metropolitan Mayors Coalition**, composed of the mayors of the state’s 28 largest cities representing more than three million citizens;
- **The Northern Trust Company** (“Northern Trust”);
- **Novelis, CTP** (“Novelis”);
- **Occupy the SEC**;
- **Office of Financial Management, Commonwealth of Kentucky** (“Kentucky Treasurer”);
- **Omaha Public Power District**, one of the largest publicly owned electric utilities in the United States, serving more than 352,000 customers in 13 southeast Nebraska counties (“Omaha”);
- **OppenheimerFunds** (“Oppenheimer”);
- **Peter Christensen**;

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- **PFM Asset Management LLC** (“PFM Group”);
- **Pima County Treasurer**;
- **Plan Investment Fund, Inc.**, a mutual fund exclusively available to qualifying licensees and affiliates of the Blue Cross and Blue Shield Association (“Plan Investment Fund”);
- **PricewaterhouseCoopers LLP**;
- **R. Mark Keener** (“Keener”);
- **Ralph S. Saul**;
- **Reich & Tang Asset Management, LLC** (“Reich & Tang”);
- **Richard B. Peters**;
- **Richard Buchan**;
- **Robert A. Woeber**;
- **Robert Comment, Ph.D.** (“Robert Comment”);
- **Ropes & Gray LLP** (“Ropes & Gray”);
- **Russell Investment Company**;
- **Samuel Hanson, Assistant Professor of Finance, Harvard Business School; David Scharfstein, Edmund Cogswell Converse Professor of Finance and Banking, Harvard Business School; and Adi Sunderam, Assistant Professor of Finance, Harvard Business School** (“HBS”);
- **SIFMA Asset Management Group, SIFMA Private Client Group, SIFMA Asset Management Group**, an organization representing hundreds of securities firms, banks and asset managers (“SIFMA”);
- **Silicon Valley Bank**;
- **Smithville**;
- **The SPARK Institute, Inc.**, an advocacy organization for the retirement plan services industry with members serving over 95% of the more than 82 million U.S. defined contribution participants (“SPARK”);
- **Spectrem Group**;
- **Squam Lake Group**, a non-partisan, non-affiliated group of 12 academics who offer guidance on the reform of financial regulation;
- **Square 1 Asset Management** (“Square 1”);
- **State Street Corporation** (“State Street”);
- **State Street Global Advisors**;
- **State Treasurer and Receiver General, Boston, Massachusetts** (“Massachusetts Treasurer”);
- **State Treasurer, Georgia** (“Georgia Treasurer”);
- **State Treasurer, State of Washington** (“Washington Treasurer”);

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- **Stradley Ronon Stevens & Young, LLP** (“Stradley Ronon”);
- **Structured Finance Industry Group**;
- **Sungard Institutional Brokerage Inc.** (“Sungard”);
- **SunTrust Bank** (“SunTrust”);
- **Susanne Lomatch**;
- **Sutherland Asbill & Brennan LLP on behalf of the Committee of Annuity Insurers**, a coalition of 28 of the largest and most prominent issuers of annuity contracts;
- **Systemic Risk Council**, an independent, non-partisan body formed by The Pew Charitable Trusts and CFA Institute (“Systemic Risk Council”);
- **T. Rowe Price Associates, Inc.** (“T. Rowe Price”);
- **TCG Financial Services LLC**;
- **Texas Short Term Asset Reserve Program**, a local government investment pool (“TexSTAR”);
- **TheBANK of Edwardsville** (“Edwardsville”);
- **ThinkNum**;
- **Thomas Lupinacci**;
- **Thrivent Financial for Lutherans** (“Thrivent”);
- **TIAA-CREF**;
- **Treasurer of North Carolina** (“North Carolina Treasurer”);
- **Treasurer, City of Chicago, Illinois** (“Chicago Treasurer”);
- **Treasurer, City of St. Louis and Comptroller, City of St. Louis** (“St. Louis Treasurer”);
- **Treasurer, Harford County, Maryland** (“Harford County Treasurer”);
- **Treasurer, State of Connecticut** (“Connecticut Treasurer”);
- **Treasury Strategies, Inc.** (“TSI”);
- **U.S. Bancorp Asset Management, Inc.** (“U.S. Bancorp”);
- **UBS Global Asset Management (Americas) Inc.** (“UBS”);
- **United Bank, Inc.** (“United Bank”);
- **United Services Automobile Association**;
- **United States Conference of Mayors**, the official non-partisan organization of the 1,398 U.S. cities with populations of 30,000 or more (“U.S. Conference of Mayors”);
- **University of Cincinnati**;
- **Utah State Treasurer**;
- **Vanguard**;
- **Virginia Chamber of Commerce**, representing over 50,000 businesses in Virginia (“Virginia Chamber”);

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- **Virginia Department of the Treasury** (“Virginia Treasurer”);
- **Waddell & Reed Investment Management Company** (“Waddell & Reed”);
- **Wells Fargo Funds Management, LLC** (“Wells Fargo”);
- **West Virginia Board of Treasury Investments**, manager of the investments for over 1,700 state agency and local government accounts;
- **William Burns**;
- **Wilmington Funds**;
- **Winford Case** (“Case”);
- **Wisconsin Bankers Association**, representing 300 commercial banks and savings institutions and their nearly 2,300 branch offices and almost 30,000 employees; and
- **Woodlands Bank**.