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Federated
WORLD-CLASS INVESTMENT MANAGER®

April 23, 2014

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

Re: Money Market Fund Reform; Amendments to Form PF, File Number S7-03-13 —Comments Regarding the Demand and Supply of Safe Assets in the Economy and Government Money Market Fund Exposure to Non-Government Securities

Dear Ms. Murphy:

This letter responds to the Securities and Exchange Commission's (the "Commission") request for comments[1] on two memoranda, each dated March 17, 2014, from the Commission's Division of Economics and Risk Analysis ("DERA") regarding (a) the Demand and Supply of Safe Assets in the Economy (the "Safe Assets Memo")[2] and (b) Government Money Market Fund Exposure to Non-Government Securities (the "Government MMF Memo," and collectively the "Memoranda").[3] The Safe Assets Memo, which incorporates the results of the Government MMF Memo, was "intended to assist the Commission in the development of final rules regarding Money Market Fund (MMF) Reform that could possibly increase the demand for [domestic government securities]."[4] Federated Investors, Inc. ("Federated") will address both Memoranda in this letter, insofar as they both assess reforms that would increase the demand for government money market instruments.

The MMF Reform referred to in the Safe Assets Memo relates to proposals made by the Commission in Investment Company Act Release No. 30551 (the "Reform Proposal").[5] The first proposed reform (termed "Alternative 1" in the Reform Proposal) would require a MMF to either: (a) limit the maximum amount a shareholder could redeem on any day to $1 million (impose a "daily redemption cap"), or else (b) calculate its net asset value per share ("NAV") in the same manner as other mutual funds, except that a MMF would round its NAV to the nearest

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1 *Staff Analysis of Data and Academic Literature Related to Money Market Fund Reform*, SEC Press Release 2014-56 (Mar. 24, 2014), http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370541253716#.UzB74oVy6F8.

2 http://www.sec.gov/comments/s7-03-13/s70313-324.pdf.

3 http://www.sec.gov/comments/s7-03-13/s70313-322.pdf.

4 Safe Assets Memo at 1.

5 78 Fed. Reg. 36834 (June 19, 2013). Terms defined in Rule 2a-7 are used with the same meanings in this letter.

basis point (calculate share prices using a "floating NAV"). The second proposed reform (termed "Alternative 2") would require a MMF to implement a 2% redemption fee if, at the end of any business day, its weekly liquid assets were less than 15% of its total assets, unless the fund's board of directors or trustees (its "Board") determines that imposing the fee is not in the best interest of the fund. Alternative 2 would also give the Board the option under these circumstances of (a) imposing a lower redemption fee or no redemption fee or (b) suspending redemptions for a period not to exceed 30 days, if it concludes that either action is in the best interest of the fund. The Commission proposed to exclude MMFs that invest more 80% or more of their total assets in government securities ("government MMFs") from either alternative. The Reform Proposal also requested comments on combining Alternatives 1 and 2.

The Commission received nearly 1,500 comment letters on the Reform Proposal.[6] "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 assets as a result."[7] Some commenters made similar predictions about the impact of Alternative 2. "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."[8]

If the Commission adopts either Alternative 1 or 2 as proposed, and exempts government MMFs from the final reform, it would be reasonable to expect a substantial portion of the assets redeemed from prime and municipal MMFs to shift into government MMFs.[9] As the Safe Assets Memo notes, during the last financial crisis, shareholders added an amount equal to over 80% of the assets redeemed from prime MMFs to government MMFs.[10] While prime MMFs shareholders engaged in a general flight to safety during the financial crisis, rather than responding to onerous regulations, they clearly regarded government MMFs as close substitutes for prime MMFs. The comments therefore provide substantial evidence that adopting Alternative 1 or a combination of Alternatives 1 and 2 could result in a wholesale shift of assets from prime and municipal MMFs to government MMFs.

The Safe Assets Memo appears to have been intended to gauge the potential impact of such a shift in assets on the capital markets. The Government MMF Memo further addresses the potential impact of requiring government MMFs to maintain more than 80% of their total assets

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[6] These comment letters were summarized in a letter from Arnold and Porter, LLP, on behalf of Federated, to the Commission (Nov. 21, 2013), http://www.sec.gov/comments/s7-03-13/s70313-282.pdf (the "Comment Summary").

[7] *Id*. at 4.

[8] *Id*. at 5.

[9] Federated has had success in educating current shareholders as to the unlikely circumstances under which MMFs would become subject to redemption fees or temporary suspensions of redemptions if Alternative 2 were adopted. We therefore anticipate that the shift of assets to government MMFs would be substantially less following adoption of Alternative 2 than following adoption of Alternative 1, particularly if Alternative 2 were modified as recommended by Federated. *See*, Comment Summary at 31. Combining Alternative 1 and 2 would result in the greatest shift of assets to government MMFs.

[10] Safe Assets Memo at 5.

in government securities. The Commission might adopt this reform in response to comments expressing concerns about allowing MMFs with any potential exposure to non-government securities to continue to maintain a stable NAV.[11]

Federated has serious reservations about the data and analysis underlying both Memoranda. Most importantly, neither Memorandum appears focused on the market sector the Reform Proposal would most directly affect, namely, the market for short-term U.S. government securities and repurchase agreements for U.S. government securities (the "government money market"). This letter will therefore assess the potential impact of a major shift of MMF assets to this sector, before addressing concerns with the analyses in the Memoranda, which rely on an overly expansive estimate of "global safe assets" to support their conclusions.

1. POTENTIAL IMPACT OF THE REFORM PROPOSAL ON THE GOVERNMENT MONEY MARKET

To properly assess the potential impact of the Reform Proposal on the government money market, the Commission needs to determine: (a) the extent to which government MMFs already participate in this sector, (b) the size of the government money market relative to the current demand for government securities by MMFs, (c) potential assets that might flow into this sector as a result of the Reform Proposal, (d) the current outlook for the growth or contraction of this sector, and (e) the potential effects of inflows into this sector.

1.1 Government MMFs' Current Holdings of Government Money Market Instruments

Data from the Investment Company Institute (the "ICI") shows total government MMFs assets of approximately $962.9 billion at the end of 2013.[12] The Government MMF Memo found that, as of November 2013, non-government securities comprised only 0.6% of government MMF assets. This suggests that it is safe to treat practically all government MMF assets as invested in government money market instruments.

The Government MMF Memo found higher levels of non-government securities in government MMFs during earlier periods, particularly prior to the end of 2011. This finding is at odds with Federated's experience. To confirm the finding, Federated obtained government MMF holdings from Crane Data as of November 2011. Our review of this data showed:

- Many government MMFs reported Straight-A Funding as "Asset Backed Commercial Paper." The SEC staff, however, had issued a no action letter authorizing MMFs to treat Straight-A Program obligations payable from loans from the Federal Financing Bank as government securities.[13]

[11] Comment Summary at 20-21 (discussing comments from the Systemic Risk Council and Federal Reserve Banks).

[12] Investment Company Institute, Summary: Money Market Fund Assets Data (Apr. 3, 2014), http://www.ici.org/info/mm_summary_data_2014.xls.

[13] Straight-A Funding, LLC, SEC No-Action Ltr., WSB File No. 0727200902 (pub. avail. July 28, 2009).

- Many government MMFs listed obligations issued by banks and bank holding companies as "Other Notes" or "Other Instruments." The Federal Deposit Insurance Corporation guaranteed these notes, however, under its Temporary Liquidity Guarantee Program ("TLGP"), making them government securities.[14] Some funds indicated this by adding "TLGP" to the security description, while others did not. TLGP only applied to obligations issued between October 14, 2008 and October 31, 2009, and expired on December 31, 2012, which is consistent with the general decline in "Other Securities" during 2012 shown in the chart on page 3 of the Government MMF Memo.

- Many of the VRDNs held in government MMFs were guaranteed by federal instrumentalities, which would make them government securities. Other VRDNs may have been Refunded Securities, which are also treated as government securities.

- Nearly all of the "Investment Companies" in which government MMFs invested appeared to be other government MMFs.

DERA may have already accounted for these discrepancies in its analysis; but if it did not, it should remove these holdings from its calculation of "Other Securities" and update its results.

In any event, Federated agrees that requiring government MMFs to hold more than 80% of their total assets in government securities—by itself—would not cause any serious dislocations to the funds or to the government money market. The high percentage of government securities held by government MMFs reflects segmentation among MMFs shareholders. Shareholders with a tolerance for minimal credit risks invest in prime and municipal MMFs, those with less risk tolerance invest in government MMFs[15] and those with no tolerance for credit risk invest in treasury MMFs. MMFs must keep their portfolios in line with their shareholders' risk tolerance to attract assets, so government MMFs generally limit their portfolios to government securities.

If the Commission adopts Alternative 1, however, shareholders in many prime and municipal MMFs will have to find alternative stable value investments regardless of the shareholders' risk tolerance. What the Commission must assess, therefore, is the risk that these shareholders will shift a significant portion of their assets to government MMFs and whether allowing government MMFs to invest in non-government securities might mitigate to some degree the effects of such a shift in assets on the government money market.

[14] http://www.fdic.gov/regulations/resources/TLGP.

[15] Shareholders seeking exemption from state income taxes may also invest in certain government MMFs that invest exclusively in state tax-exempt federal obligations and do not engage in repurchase agreements.

1.2 Current Capacity of the Government Money Market

According to data from J.P. Morgan Securities[16] and the Federal Reserve Bank of New York,[17] Federated estimates the size of the government money market at the end of 2013 as follows:

TABLE A	
Type of Security	**Amount Outstanding (in billions)**
Treasury Bills	$1,592
Treasury Coupons	$1,567
Agency Discount Notes	$ 509
Agency Coupons	$ 427
Fully Collateralized Tri-Party Repurchase Agreements	$1,184
Total Government Money Market	$5,279

As noted above, government MMFs held approximately $963 billion of this $5.279 trillion of government securities. Based on information from Crane Data, Federated estimates that prime MMFs held another $95 billion in Treasury securities, $130 billion in agency securities and $169 billion in fully collateralized repurchase agreements. Federated does not believe that municipal MMFs held government securities to any meaningful extent, as interest from these securities is subject to regular federal income tax. Subtracting the government security holdings of prime and government MMFs from the result in Table A leaves $3.922 trillion in government money market instruments that government MMFs might purchase if they received substantial assets from former prime and municipal MMFs shareholders.

1.3 Potential Impact of MMF Reform on the Demand for Government Money Market Instruments

The ICI reported year-end assets in prime MMFs of approximately $1.486 trillion. If we subtract from this the amount of government securities already held by prime MMFs, this leaves $1.092 trillion as the potential demand for government money market instruments if shareholders

[16] J.P. Morgan Securities LLC, *US Fixed Income Markets Weekly: Short-Term Fixed Income* at 3, Ex. 5 (Apr. 4, 2014).

[17] Federal Reserve Bank of New York, Tri-Party Repo Statistics as of 01/10/2014, http://www.newyorkfed.org/banking/xls/jan14_tpr_stats.xls. This is the information available closest to the end of the 2013, and avoids temporary supply fluctuations in the repo market associated with year end. "Fully collateralized" repurchase agreements include all agency and U.S. Treasury collateral, reduced by their median reported margin.

We did not include FICC data due to the risk of double counting, which arises when dealers intermediate repurchase agreements. For example, if Dealer A executes a $100 million repurchase agreement with one client, then reverses the repurchase agreement to Dealer B, which then executes a $100 million repurchase agreement with its client, this might be counted as $300 million in repurchase agreements, even though it is actually a $100 million intermediated by two dealers. The Tri-Party Repo Statistics avoid double counting by measuring the collateral held by tri-party sub-custodians for repurchase agreements rather than the amount of repurchase obligations.

moved the assets held in prime MMFs at the end of 2013 to government MMFs. If shareholders in municipal MMFs also moved their assets to government MMFs, this would have resulted in demand for an additional $271 billion of government money market instruments.

These numbers represent the highest end of the range of MMF assets that might shift into government MMFs following adoption of MMF reforms. As Alternative 1 would allow MMFs with daily redemption caps, which it refers to as "retail" funds, to continue to operate in much the same manner as current prime and municipal MMFs, the shift of assets to government MMFs should be less than this amount. Federated cannot estimate how many assets might be retained in such MMFs, however, insofar as the Commission's proposed definition of "retail" would not correspond to any existing classification of retail funds.

Moreover, it is unlikely that all of the assets held in prime and municipal MMFs would be shifted to government MMFs. Federated expects that many investors will also shift their assets to large, "too big to fail," banks.[18] However, we have not found any basis for estimating the extent to which prime and municipal MMF shareholders would prefer bank instruments to government MMFs.

Given our inability to predict how many assets might shift from prime and municipal MMFs to government MMFs in response to adoption Alternative 1 or 2, or a combination thereof, Federated recommends that the Commission analyze and consider a range of outcomes, such as those shown in the following Table B.

TABLE B		
Potential Impact	**Non-Government Assets (in billions)**	**% of Available Supply**
All Prime & Municipal MMF Assets	$ 1,363	34.7%
All Prime MMF Assets	$ 1,092	27.8%
75% of Prime MMF Assets	$ 819	20.9%
50% of Prime MMF Assets	$ 546	13.9%
25% of Prime MMF Assets	$ 273	7.0%

This approach also would permit the Commission to assess how modifications to the Reform Proposal might mitigate its impact on the demand for government money market instruments. For example, Table B shows that excluding municipal MMFs from the Reform Proposal, as recommended by most commenters,[19] would avoid a potential increase in demand equal to approximately 7% of the current government money market.

The Commission should also consider how the proposed definition of a government MMF, which would permit investment of up to 20% of total assets in non-government securities,

[18] Shareholders might also shift assets into direct holdings of government money market instruments, which would have the same impact on the sector as shifting assets into government MMFs. It seems unlikely, however, that an investor currently using a prime MMF would invest directly in government securities rather than shifting to a government MMF.

[19] *See*, Comment Summary at 33-39.

might mitigate any shift in assets to government MMFs. Twenty percent of government MMF assets was equivalent to approximate 4.9% of the available supply at the end of 2013. Although not every government MMF should be expected to increase its holdings of non-government securities, repositioning existing portfolios could offset an increase in demand by a few percent. More importantly, having to invest only 80% of assets shifted from prime and municipal MMFs in government money market instruments would reduce the increase in demand by a corresponding amount.

The Commission should also broaden its historical perspective to account for the potential growth of MMF assets relative to the government money market. According to the ICI, at the end of 2008, government MMF assets were $1.490 trillion, while assets in prime MMFs were $1.849 trillion and municipal MMFs were $494 billion. Altogether, MMFs assets at the end of 2008 were $1.113 trillion higher than at the end of 2013. Asset levels from 2008 and earlier should provide better indications of the potential demand for MMFs under normal interest rate conditions; demand that would be focused on government MMFs to the extent prime and municipal MMFs are forced to float their NAVs. Higher interest rates are typically associated with economic expansion, which tends to increase federal revenues and lower deficits. The Commission should therefore anticipate market conditions in which the demand for government MMFs increases more rapidly than the supply of government money market instruments.

1.4 Other Factors Affecting Supply and Demand for Government Money Market Instruments

Federated hopes that DERA's interest in "safe assets" reflects the Commission's concern for the unintended consequences from the interactions of various regulatory reforms. In particular, there is a risk that financial reforms that increase demand for "safe assets," including changes to capital and liquidity requirements, collateral requirements for financial contracts, and restrictions on MMFs, may overwhelm the supply of such assets. According to a study cited in the Safe Assets Memo, "macroeconomic shortages of safe assets can create financial instability."[20]

Regarding the supply of government money market instruments, the eventual resolution of the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation will reduce this supply. These two government sponsored enterprises accounted for at least $216 billion of the short-term agency obligations outstanding at the end of 2013. Currently proposed legislation would replace both enterprises with a Federal Mortgage Insurance Corporation,[21] which would guarantee mortgage-backed securities but not issue direct obligations. Enactment of this or similar legislation will substantially curtail the supply of government money market instruments. Even without such reforms, J.P. Morgan expects a decrease of over $100 billion in

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[20] Pierre-Olivier Gourinchas and Olivier Jeanne, *Global Safe Assets*, BIS Working Paper No 399, at 2 (2012).

[21] *See*, Summary of Senate Banking Committee Leaders' Bipartisan Housing Finance Reform Draft, http://banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=2cbe807d-0b28-4980-b017-1cb1a43079ef.

agency money market instruments, and an even larger reduction in dealer repurchase agreements in response to pressure to reduce reliance on short-term funding.[22]

The Federal Reserve Bank of New York's Reverse Repo Program[23] has become a growing presence in the market that might offset reductions in other types of government money market instruments. The Federal Reserve might even use the program to expand the current size of the government money market. Counteracting the unintended consequences of the Commission's reforms may not be an appropriate use, however, of a monetary policy tool such as the Reverse Repo Program. Countervailing policy concerns may also force the Federal Reserve to curtail the program, making this an unreliable source of supply to the government money market. Finally, we are not aware of any study of the potential long-term effects on the capital markets if the Federal Reserve played the role of "supplier of last resort" to the government money market.

Growth in the U.S. Treasury's public debt will continue to be a source of supply to the government money market in the near term. However, the rate of growth has been slowing since the financial crisis. The projected deficit for fiscal 2014 is only half of that in 2009, and is expect to decline still more in 2015.[24] While continued contraction in the federal deficit or a return to a surplus would be good news for the general economy, it would also create uncertainty as to the supply of government money market instruments. Furthermore, the Treasury's efforts to extend the maturity of the public debt will continue to exacerbate supply shortages in the government money market.

Meanwhile, various factors have increased demand for government securities. First, the Federal Reserve holds an enormous amount of government securities as a result of quantitative easing and other policy initiatives. Second, continued trade deficits and other market factors foster demand for U.S. government securities by foreign central banks, sovereign wealth funds and other foreign institutions. Third, structural and regulatory changes in the markets for financial contracts (including derivatives) have increased the demand for government securities as collateral. Fourth, regulatory capital and liquidity requirements have increased incentives for financial institutions to hold government securities. Although none of these factors is limited to the government money market, they contribute to an overall increase in the demand for government money market instruments. In summary, the Commission should plan for a substantial contraction in the size of the government money market while demand for government money market instruments increases, even without the adoption of the Proposed Reform.

1.5 Potential Effects of a Shift in Assets to Government MMFs

Given the size of prime and municipal MMFs and the comments of their shareholders on the Reform Proposal, the Commission should anticipate a shift of hundreds of billions of dollars into government MMFs in response to its adoption of Alternative 1 or a combination of Alterna-

[22] J.P. Morgan Securities LLC, *supra* note 16, at 3, Ex. 7.

[23] http://www.newyorkfed.org/markets/rrp_faq.html.

[24] Congress of the United States Congressional Budget Office, *The Budget and Economic Outlook: 2014 to 2024*, Fig. 1-1 (Feb. 2014).

tives 1 and 2. A potential shift in the range of one-half to one trillion dollars might be an appropriate magnitude for consideration, rather than the $357 billion arbitrarily chosen in the Safe Assets Memo. The Commission should further consider the possibility of an additional $1 trillion or more in demand for government MMFs as the Federal Reserve allows short-term interest rates to return to normal levels.

We should note initially that the Safe Assets Memo does not attempt to consider the most important impact of such a shift; namely, the withdrawal of hundreds of billions of dollars from the private capital markets. As capital formation and market efficiency are among the Commission's core objectives, such a wholesale reduction in capital and dislocation of the capital markets must be considered in any final rulemaking. Perhaps an analysis of the impact of such a shift in assets from private capital markets will be among the "Additional studies, memoranda, or other substantive items [that] may be added by the Commission or staff to the comment file during this rulemaking." Any such analysis would benefit from public review and comment.

With respect to the potential impact of reform on the government money market, the Safe Assets Memo assumes "The fungibility and hence substitutability of global safe assets in other contexts (but not for money market funds) would likely free up supplies of domestic government securities elsewhere."[25] This presumes that government MMFs are the only "contexts" in which investment in domestic government securities would be required, which is not the case. Federated and other asset managers regularly receive mandates limited to investments in government securities. These limits may be imposed by law or by the terms of an indenture or other contract. Foreign central banks and sovereign wealth funds may also be required to hold U.S. government securities as reserves. In addition, certain types of securities, such as refunded municipal bonds, require government securities as collateral.

Even where investors have the legal right to invest in non-government securities, the economic terms may be so prohibitive as to make these alternatives far from "fungible" for government securities. For example, CME Clearing will only accept as collateral for its cleared financial contracts government securities, cash, MMFs, foreign sovereign debt and gold.[26] Only large firms may margin gold, however, and at a 15% haircut to its market value. Foreign sovereign debt is limited to still larger firms, with a 5% haircut for bills and haircuts from 6% to 10.5% for notes and bonds, depending on their term. Gold, foreign sovereign debt and Treasury inflation protected securities cannot exceed the least of 40% or $5 billion of a firm's overall margin; the balance must consist of domestic government securities and MMFs.

In contrast, the CME Clearing haircut for Treasury bills is only 0.5%. There is a 1% haircut for Treasury notes with under a year to maturity, as compared to haircuts from 2% to 6% for longer-term Treasury securities. The haircut for agency discount notes and bills is 3.5%. Haircuts for other direct agency obligations range from 4% to 7%; the haircut on agency mortgage-backed securities is 11%. Such steeply graded haircuts create strong economic incentives to use govern-

[25] Safe Assets Memo at 1.

[26] http://www.cmegroup.com/clearing/financial-and-collateral-management/collateral-types-accepted-cds.html.

ment money market instruments as collateral. Scarcity of such collateral would increase the cost of trading contracts and would reduce market efficiency.

Similar economic incentives to invest in government securities may be found in regulatory capital and liquidity requirements. For example, the proposed liquidity coverage ratio for bank holding companies and other covered institutions would treat obligations backed by the full faith and credit of the United States as Level 1 High Quality Liquid Assets, while obligations of federal agencies would be classified as Level 2 High Quality Liquid Assets subject to a 15% haircut and investment grade corporate securities would be classified as Level 3 High Quality Liquid Assets subject to a 50% haircut.[27] Level 2 and 3 High Quality Liquid Assets would also be subject to an overall limit of 40% of total High Quality Liquid Assets.

Thus, it is not axiomatic that increased demand for government securities from government MMFs would "free up supplies of domestic government securities" from other investors. Many other investors (including firms that have reach their limits on alternative forms of High Quality Liquid Assets or margin collateral) will continue to need a regular supply of government securities. Other investors will find the cost of substituting government securities for other "safe assets" prohibitive. Therefore, any increase in demand for government money market instruments, particularly given the anticipated reduction in their supply, will necessarily increase their price and, thus, the cost of transacting in the capital markets.

Such a supply/demand imbalance could even result in negative yields on government money market instruments. Although the memo blithely observed that "Despite absorbing $409 billion of assets, rates became negative in only a few instances,"[28] this was an unprecedented event in the government money market. Federated has not found any instance prior to the financial crisis in which significant amounts of Treasury bills were sold at prices in excess of their face value. Given that MMF reform is likely to produce an even larger shift of assets into the government money market, in conjunction with other regulatory changes that are increasing demand and curtailing supply, the Commission cannot disregard the risk that MMF reforms may lead to negative yields for government money market instruments.

Negative yields can have serious repercussions for government MMFs. A MMF cannot invest in a portfolio of securities that generate net losses rather than net income and maintain a stable NAV. A period of sustained negative yields would force government MMFs to "break a dollar," thereby destroying what the Commission seeks to preserve by exempting government MMFs from the reform alternatives.

Negative yields also have significant repercussions for other investors, insofar as it requires them to accept losses on their investments. Forcing investors to take losses on what are supposed to be their safest investments would be contrary to the Commission's mission of pro-

[27] *Liquidity Coverage Ratio: Liquidity Risk Management, Standards, and Monitoring*, 78 Fed. Reg. 71818 (proposed Nov. 29, 2013).

[28] Safe Assets Memo at 6.

tecting investors. This may nevertheless be an unintended consequence of artificially constraining investors' alternatives for managing their cash investments.

Even if yields do not become negative, higher prices and increased competition for scarce government money market instruments will necessarily reduce the efficiency of the U.S. capital markets. Trading that relies on government securities for collateral and intermediaries that must hold such securities as capital will experience the most adverse consequences. Shifting capital to the government money markets will also decrease the supply of working capital for private companies, increasing the cost of short-term funding and reducing efficiency in that market as well. Such reductions in efficiency will discourage capital formation and make U.S. capital markets less competitive in general. The Commission must weigh all such expected costs against any purported benefits of its final rulemaking.

2. IRRELEVANCE OF "SAFE ASSETS" TO MONEY MARKET FUND REFORM

According to the Safe Assets Memo, "A safe asset is defined as any debt asset that promises a fixed amount of money in the future with virtually no default risk [and] are generally considered to be information insensitive."[29] The Safe Assets Memo nevertheless includes assets with significant default risks and assets that are not "information insensitive" in its estimated amounts of "safe assets." For example, the estimated $74 trillion of global safe assets cited in the Safe Assets Memo includes $12.9 trillion of securitized assets, including residential mortgage backed securities.[30] These were the primary source of financial instability during the financial crisis, and should not be considered "safe assets."

Other "safe assets" included in the $74 billion estimate were gold ($8.4 trillion) and investment grade corporate debt ($8.2 trillion). These assets have never been regarded as "information insensitive," as investors expend substantial time and resources collecting information on these assets throughout every day. This is one of the points made in the Goldman Sachs report cited in the Safe Assets Memo, which estimated (using more rigorous criteria) that global safe assets were over $30 trillion at the end of 2011.[31]

Moreover, default risk is not the only risk relevant to cash investors. For example, foreign exchange risk would be very significant to any investor needing U.S. dollars. A company that has to pay its bills in U.S. dollars cannot afford to invest in euro denominated paper, no matter how low its default risk. The Goldman Sachs report estimated U.S. dollar denominated "safe assets" at $20 trillion at the end of 2011.[32]

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[29] Safe Assets Memo at 1.

[30] International Monetary Fund, *Global Financial Stability Report: The Quest for Lasting Stability* at 89, Fig. 3.4 (Apr. 2012), http://www.imf.org/External/Pubs/FT/GFSR/2012/01/pdf/text.pdf.

[31] Goldman Sachs, *Global Economic Weekly: Are There Fewer "Safe" Assets than Before?* at 5, Chart 6 (June 27, 2012), http://www.realclearmarkets.com/blog/0627_globalecs.pdf.

[32] *Id*. at 4, Chart 3.

Even this amount of safe assets must be reduced to account for market risk. It is not realistic to assume that cash investors, who typically invest exclusively in money market instruments, would willingly accepted the fluctuations in market value associated with a long-term Treasury note or bond, much less a pool of 30-year government guaranteed mortgages. The need to constrain market risk is precisely why Rule 2a-7 imposes strict maturity limits, both on the overall maturity of portfolio securities as well as the weighted average maturity of the portfolio as a whole. When the maturity of "safe assets" is similarly constrained, the total is reduced to the amount of government money market instruments analyzed in the preceding section. As we have shown, if this more appropriate benchmark for "safe assets" is used, the potential cost of shifting assets from prime and municipal MMFs to government securities could be very significant.

The Safe Assets Memo finds that "it is difficult to envision such flows [from prime and municipal MMFs to government MMFs as a result of MMF Reform] would create a problem."[33] It is not clear whose problems DERA was attempting to "envision." Shifting hundreds of billions or even a trillion dollars into the government money market would not necessarily "create a problem" for holders of gold, investment grade bonds, securitized assets or foreign sovereign obligations. Nevertheless, it would certainly create problems for investors who are required to invest in government securities or who cannot afford the risks associated with these other classes of "safe assets" included in the Safe Assets Memo.

Assessing the impact of the Reform Proposal based on the supply of global "safe" assets is like assessing the diversion of irrigation water based on the depths of the oceans. Practically unlimited amounts of water that are not available, and could not be used for irrigation in any event, are unlikely to comfort a drought stricken farmer. Similarly, the "safe" assets cited by DERA would be of no use to U.S. cash investors deprived of prime and municipal MMFs or other investors crowded out of the government money market by a shift in assets to government MMFs.

3. CONCLUSIONS

In summary, this comment letter establishes the following facts that the Commission should account for in any cost/benefit analysis of the Reform Proposal.

1. At the end of 2013, assets held in prime and municipal MMFs that could shift to government MMFs exceeded \$1.3 trillion. Although not all of these assets would flow into government MMFs following adoption of any of the alternative reform proposals, comment letters indicate that adoption of Alternative 1, whether on its own or in combination with Alternative 2, will produce a sizable shift in assets. The Commission should therefore anticipate a larger shift in assets than the \$357 billion arbitrarily assumed in the Safe Assets Memo.

2. Historical evidence indicates that, if Alternative 1 were adopted, demand for government MMFs could increase by an additional \$1 trillion when short-term interest rates return to normal levels.

[33] Safe Assets Memo at 5.

3. The government money market, rather than “global safe assets,” is the relevant market for assessing the impact of a shift of assets to government MMFs. When government securities already held by MMFs are taken into account, this narrows the available supply from $74 trillion to just under $4 trillion.

4. Other regulatory reforms, particularly enhanced capital and liquidity requirements for financial institutions and margin requirements for financial contracts, have and will continue to contribute to increased demand in the government money market. At the same time, reductions in the federal deficit, efforts to extend the maturity of the public debt, reform of government sponsored enterprises and constraints on the use of repurchase agreements by major financial institutions have and will continue to limit supply for the government money market.

5. Increasing the supply/demand imbalance in the government money market will increase the price of government money market instruments, thereby increasing the capital and transaction costs to financial institutions that depend on these instruments. Such increased costs will reduce market efficiency and competitiveness, and discourage capital formation.

6. Increasing demand for government money market instruments during a period of historically low interest rates creates a risk of negative yields. Negative yields force investors to incur losses on what are supposed to be their safest investments, and may result in many government MMFs breaking a dollar. A sustained period of negative yields would also discourage capital formation and reduce efficiency and competition in the capital markets.

7. The Commission’s cost/benefit analysis will be incomplete unless it also considers the impact of a shift in assets to government MMFs on the private capital markets.

Federated appreciates the opportunity to comment on the Memoranda and the Commission’s consideration of our comments. Please feel free to contact me if you have any questions regarding these comments.

Very truly yours,

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