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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 SEC Staff Analysis of Liquidity Cost During Crisis Periods

Dear Ms. Murphy:

We are writing on behalf of our client Federated Investors, Inc. and its subsidiaries ("Federated") to comment on the analysis prepared by the Division of Economic and Risk Analysis ("DERA") of same-day buy and sell transaction prices for Tier 1 and Tier 2 eligible securities from January 2, 2008 to January 31, 2009 (the "Analysis").[1] We understand DERA prepared this analysis in connection with the review by the Securities and Exchange Commission (the "Commission") of proposed rules regarding the regulation of money market mutual funds ("MMFs"), including any possible liquidity fee.[2] Federated previously filed comments recommending modifications to the Commission's proposed Alternative 2, including with respect to the criteria for imposing a liquidity fee, which should be imposed only in rare and extreme circumstances.[3]

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[1] Division of Risk and Economic Analysis, *Liquidity Cost During Crisis Periods* (Mar. 17, 2014) (available in File No. S7-03-13) (the "Analysis").

[2] *Money Market Fund Reform; Amendments to Form PF*, Investment Company Act Release No. 30551, 78 Fed. Reg. 36834 (proposed June 19, 2013) ("Release").

[3] Letter from John W. McGonigle, Vice Chairman, Federated to Commission (Sept. 16, 2013) (available in File No. S7-03-13). Federated recommended reducing the threshold for weekly liquidity assets that would require a Board to consider the imposition of a liquidity fee or temporary suspension of redemptions to 10% (rather than 15%) of total assets; reducing the maximum period of suspension of redemptions and liquidity fees to 10 (rather than 30) calendar days; and permitting a Board to use these authorities *before* the

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Federated is pleased that DERA is conducting a detailed analysis of the cost of liquidity during economic stress periods and presumes that DERA's findings will inform the Commission's final determination of the appropriate size of any liquidity fee, if the Commission determines to include a liquidity fee in forthcoming final rules applicable to MMFs. Federated generally agrees with DERA's methodology for considering the cost of liquidity in evaluating an appropriate liquidity fee. A comparison of the average difference between same-day buy and sell transaction prices (commonly referred to as the "spread") for Tier 1 and Tier 2 eligible securities is a useful method of analysis to employ in that consideration.[4]

Federated believes, however, that DERA's use of Trade Reporting and Compliance Engine (TRACE) bond data as the basis for spread analysis led DERA to find significantly larger spreads than it would have found had it based its analysis on the short-term instruments in which MMFs actually invest. Using TRACE data to sample Tier 1 and Tier 2 eligible securities that have a maturity of more than one year at issuance, DERA found that the average spread during non-crisis periods is approximately 25 basis points ("bps") for both Tier 1 and Tier 2 eligible securities and that the crisis period spread peaked around 72.4 bps for Tier 1 eligible securities and 137.5 bps for Tier 2 eligible securities.[5]

Federated is an active investor for its client mutual funds' accounts in both money market instruments and in long and medium-term bonds, and through its investment teams has experience involving spreads for Tier 1 and Tier 2 eligible securities with an

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end of a business day if it determines there is a substantial risk that a prime MMF's weekly liquid assets will be reduced to less than 10% of its total assets before the end of a business day or it determines that such an action is appropriate to avoid material dilution or other unfair results to shareholders. Federated also recommended that the Commission state in any release adopting Alternative 2 that the Commission expects that Boards will impose liquidity fees or suspensions of redemptions rarely and only for so long as necessary to protect the interests of shareholders. Federated also recommended exempting tax exempt fund from the liquidity fee and temporary suspension requirements, if Alternative 2 is adopted.

[4] The Analysis' definition of Tier 1 and Tier 2 eligible securities corresponds to the terms "First Tier Securities" and "Second Tier Securities," respectively, defined in Rule 2a-7. 17 C.F.R. § 270.2a-7.

[5] The text and accompanying tables of the Analysis contain different estimates of these numbers. The text describes the crisis period liquidity spreads at approximately 70 bps for Tier 1 eligible securities and 160 bps for Tier 2 eligible securities. The accompanying tables show 72.4 bps for Tier 1 eligible securities and 137.5 bps for Tier 2 eligible securities.

original maturity of one year or less (*i.e.*, Rule 2a-7 eligible instruments at time of issuance) as well as long and medium term bonds that have short remaining terms to maturity. In Federated's experience, the spread for those securities that were money market instruments at time of issuance, during non-crisis periods, is approximately 1-2 bps, and the spread during crisis periods is approximately 15-25 bps. In Federated's experience, the additional spread on TRACE-eligible bonds with original terms in excess of one year, as they near maturity, is 1-22 bps above that of money market instruments of comparable quality and remaining term. Federated's experience suggests that the Commission should reconsider the proposed 200 bps (or 2%) liquidity fee in favor of a liquidity fee that reflects the typical crisis spreads of Rule 2a-7 eligible instruments. Federated believes an appropriate liquidity fee may be as low as 50 bps (0.5%).

DERA's use of TRACE data, which tracks long-term investments, produced exaggerated spreads.

The TRACE system provides transaction records for certain corporate and agency bonds and related securities. As DERA states in its analysis, the TRACE system only collects data for instruments that have a maturity of more than one year at issuance. Similar instruments with an original maturity of less than one year (*i.e.*, instruments eligible for investment by MMFs at the time of issuance), are not reported in TRACE. In recognition of this data issue, DERA states that it "include[d] in the samples only trades of bonds with fewer than 120 days to maturity and with a trade size of at least $100,000," and that as a result the samples it constructed have "similar time-to-maturity and credit risk characteristics as those permitted under Rule 2a-7."[6]

Although MMFs are permitted to invest in TRACE-eligible securities as they near maturity if they otherwise meet the investment criteria of the MMF and Rule 2a-7, the great majority of portfolio assets of a MMF are shorter-term money market instruments that are not TRACE-eligible.

While DERA's samples may very well have mirrored the credit risk characteristics of Rule 2a-7 investments, Federated respectfully disagrees that DERA could approximate the likely spreads of Rule 2a-7 permissible investments during a crisis period by limiting its sample to long-term bonds with fewer than 120 days to maturity. In Federated's experience, at a given time-to-maturity, instruments with an original maturity

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[6] Analysis at 2.

of over one year tend to have significantly wider spreads than instruments with an original maturity of under one year. In other words, even though DERA's sample included instruments with a time-to-maturity similar to Rule 2a-7-eligible investments, Federated would expect DERA's average spreads to be larger than if DERA had sampled instruments with an original maturity of less than one year.

The wider observed spreads are largely due to the behavior of investors in long-term instruments. Investors in longer term bonds seek to maintain a relatively long weighted-average portfolio maturity (WAM). In order to maintain the longer WAM, the investors will often sell these bonds close to maturity and use the proceeds to purchase newly-issued bonds with longer maturities. Traders of long-term and medium-term bonds often sell those instruments prior to maturity, at a slightly lower price than implied by the going market price for a newly issued money market instrument of similar remaining maturity, when the trader is seeking liquidity to take advantage of an investment opportunity in new long or medium-term bonds with a higher rate of interest than the implied rate over the remaining term of the older bond nearing redemption. This behavior is reflected in a wider bid-ask spread for long and medium-term bonds as they approach maturity. The market for money market instruments that are eligible for investment by a MMF at the time of issuance, on the other hand, has a much narrower liquidity spread than TRACE-eligible bonds with short remaining maturity.

It should be kept in mind that MMFs currently hold, on average, well over 40% of their portfolio assets in near cash assets that will convert to cash in less than seven days (without sale into the markets and a consequent liquidity spread from sale),[7] and the natural maturity of these assets – not the sale of longer-term MMF portfolio assets held in portfolio – would be the source of cash used to pay redeeming investors in the first instance. Moreover, other U.S. government securities held in a MMF's portfolio are also available for sale if needed to meet redemptions. The securities generally are sold at a premium to amortized cost during periods of economic stress, and thus a liquidity fee to reflect a potential cost of their sale to meet redemptions would not be necessary.

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[7] Investment Company Institute, *Money Market Fund Holdings – March 2014* (Apr. 16, 2014), *available at* http://www.ici.org/research/stats/mmfsummary/nmfp_03_14.

Federated's experience indicates that the spreads for Rule 2a-7 eligible securities are much smaller than DERA's Analysis would suggest.

Using DERA's basic methodology of comparing the spreads for such Tier 1 and Tier 2 eligible securities during both crisis and non-crisis periods,[8] Federated's experience is that the spread for Tier 1 and Tier 2 eligible securities during non-crisis periods is approximately 1-2 bps, and that the spread during crisis periods is approximately 15-25 bps on Tier 1 eligible securities and 15-40 bps on Tier 2 eligible securities. Typically, the spread on Tier 2 eligible securities is slightly higher to that on Tier 1 eligible securities.

Taking further into account that the one-day and seven-day liquid assets held in portfolio would not be subject to liquidity spreads as they mature and convert to cash, and taking into account the fact that longer-term U.S. government securities generally sell at a premium to amortized cost in a financial crisis, whatever liquidity spread one attributes to money market assets that are neither U.S. government securities nor instruments with seven or fewer days remaining maturity, that liquidity spread needs to be adjusted downward based upon the percentage that such assets comprise of the MMF's portfolio as a whole. In other words, if the liquidity spread in a crisis is deemed to be 50 bps for money market instrument with more than seven days remaining maturity that are not U.S. government securities, and half of the MMF's portfolio consists of weekly liquid assets and U.S. government securities, the liquidity spread for the portfolio as a whole would be 25 bps.

Federated also is aware of a study by the Investment Company Institute ("ICI") which analyzed sell-side trade data submitted by ICI's members for the period from September 12, 2008 to September 19, 2008. ICI found that the simple average deviation from amortized cost for all those trades was negative 21 bps. After assuming that bid-ask spreads widened equally on both sides, ICI concluded than an "upper limit" for the total transaction would have been around 40 bps. Of course, spreads may or may not have widened equally in the fashion ICI assumes, suggesting that ICI's numbers are wholly consistent with Federated's analysis.

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[8] For this purpose, Federated considered September 12, 2008 through October 20, 2008 to be a crisis period and all other dates to be non-crisis periods.

Data from Federated and other industry participants suggests any liquidity fee should be set lower than the Commission's proposal of two percent.

The Analysis suggests that DERA's findings will be used to inform the Commission's ultimate determination of any liquidity fee included in final MMF rules. Federated is pleased that the Commission is considering carefully the available data in its rulemaking determinations. As discussed above, however, because DERA's data sample was limited to TRACE-eligible securities, we believe the Analysis overstates the spreads for Rule 2a-7 eligible securities during crisis periods by several multiples of actual spreads, and thus may lead the Commission to adopt a far larger-than-necessary liquidity fee. The analyses produced the ICI and the experience of Federated both suggest that a small liquidity fee than originally proposed would be appropriate. Federated believes an appropriate liquidity fee may be as low as 50 bps (0.5%).

We appreciate the opportunity to comment upon the DERA Analysis. Federated would be happy to discuss its analysis at the Commission's convenience.

Respectfully,

David F. Freeman, Jr.