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April 25, 2014

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

Re: Money Market Fund Reform; Amendments to Form PF, File Number S7-03-13 — Response to FRBNY Staff Paper on Alternative 2- Fees and Gates

Dear Ms. Murphy:

We are writing on behalf of our client Federated Investors, Inc. and its subsidiaries ("Federated") to respond to a paper published last week by the Staff of the Federal Reserve Bank of New York ("FRBNY") on the FRBNY website, titled "Gates, Fees, and Preemptive Runs"[1] ("FRBNY Staff Gates & Fees Paper"). The FRBNY Staff Gates & Fees Paper analyzes Alternative Two (the "Fees and Gates" proposal) of the rulemaking proposal regarding money market mutual funds ("MMFs") currently before the Securities and Exchange Commission (the "Commission").[2]

The abstract accompanying the FRBNY Staff Gates & Fees Paper states:

> We build a model of a financial intermediary, in the tradition of Diamond and Dybvig (1983), and show that allowing the intermediary to impose redemption fees or gates in a crisis—a form of suspension of convertibility—can lead to preemptive runs. In our model, a fraction of investors (depositors) can become informed in advance about a shock to

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[1] Marco Cipriani, Antoine Martin, Patrick McCabe, Bruno M. Parigi, *Gates, Fees, and Preemptive Runs,* FRBNY Staff Report No. 670 (Apr. 2014) *available at* http://www.ny.frb.org/research/staff_reports/sr670.pdf.

[2] *Money Market Fund Reform*; Amendments to Form PF, 78 Fed. Reg. 36834 (June 19, 2013) ("Release"). Prior letters from Federated and Arnold & Porter LLP are available in the Commission's File No. S7-03-13.

> the return on the intermediary's assets. Later, the informed investors learn the realization of the shock and choose their redemption behavior based on this information. We prove two results: First, there are situations in which informed investors would wait until the uncertainty is resolved before redeeming if redemption fees or gates cannot be imposed, but those same investors would redeem preemptively if fees or gates are possible. Second, we show that for the intermediary, which maximizes the expected utility only of its own investors, imposing gates or fees can be ex post optimal. These results have important policy implications for intermediaries that are vulnerable to runs, such as money market funds, because the preemptive runs that can be caused by the possibility of gates or fees may have damaging negative externalities.

The FRBNY Staff Gates & Fees Paper notes that, "In the banking literature, suspension of convertibility of deposits into cash was long seen as a mechanism to prevent self-fulfilling bank runs"[3] and concedes that its analysis and conclusions "that the possibility of suspending convertibility, including the imposition of gates or fees for redemptions, can create runs that would not otherwise occur . . . contrasts with the existing literature, which focuses on whether suspension of convertibility can prevent runs."[4] Nonetheless, the FRBNY Staff Gates & Fees Paper finds "that rather than being part of the solution, redemption fees and gates can be part of the problem."[5]

The thesis of the FRBNY Staff Gates & Fees Paper is that Alternative Two would add to systemic risk by providing for the first time MMF board of directors with authority to impose fees and/or gates in a crisis, which new authority would cause shareholders in times of financial uncertainty to place redemption orders early in anticipation of gates and fees being imposed at a later date, thereby triggering an anticipatory run on MMFs. A key premise of the FRBNY Staff Gates & Fees Paper is that MMFs and banks are *currently* prohibited from imposing gates and fees. The FRBNY Staff Gates & Fees Paper states at page 3 that "neither individual U.S. banks nor individual MMFs have had the legal option to suspend convertibility . . . ." The FRBNY Staff Gates & Fees Paper

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[3] FRBNY Staff Gates & Fees Paper at 2.

[4] *Id.* at 3.

[5] *Id*. at 2.

describes its "results, including our finding that restrictions on redemptions or withdrawals can be *ex post* optimal for the financial intermediary, [as] provid[ing] a theoretical basis for understanding why such restrictions may ***have been forbidden***."[6] The FRBNY Staff Gates & Fees Paper argues against Alternative Two by claiming that regulatory changes which supply "[a]n intermediary [with the] ability to impose restrictions can trigger preemptive runs . . . ."[7]

The key assumption underlying the entire analysis, that banks are currently prohibited from imposing gates or fees on redemptions, is demonstrably false. Other than demand deposit accounts ("DDAs"), banks (1) are required by Federal Reserve Regulation D to reserve the right to require seven days' advance notice of a withdrawal from MMDAs, NOW accounts and other savings accounts; (2) are not required to allow early withdrawal from CDs and other time deposits; and (3) are allowed to impose early withdrawal fees on time deposits if they choose to permit an early withdrawal from a time deposit.

The Federal Reserve Act and Federal Reserve Regulation D require all banks to retain contractual authority as to most deposits to postpone withdrawals (gating) or impose early redemption fees. Section 19 of the Federal Reserve Act of 1913 (12 U.S.C. § 461, "Reserve Requirements") and Section 7 of the International Banking Act (12 U.S.C. § 3105(a), "Bank Reserves"), together with Federal Reserve Regulation D thereunder (12 C.F.R. § 204, "Reserve Requirements of Depository Institutions") have long required banks to reserve the right to impose restrictions – either gates or fees or both – on redemptions of all bank deposits other than demand deposit accounts ("DDAs"). DDAs represent less than 9% of large bank deposits.[8] Any deposits that do not qualify as time or savings deposits through the retained right in the bank to impose gates and/or fees are deemed to be DDAs and the bank must hold 10% liquid assets against aggregate DDA balances by placing reserves on deposit with the local Federal Reserve Bank.

[6] *Id*. at 3 (emphasis added).

[7] *Id*. at 3.

[8] Federal Financial Institutions Examination Council, *Uniform Bank Performance Report -- Peer Group Average Reports* (data as of Dec. 31, 2013), *available at* https://www.ffiec.gov/ubpr.htm.

By definition, a DDA is "a deposit that is payable on demand, or a deposit issued with an original maturity or required notice period of less than seven days, or a deposit representing funds for which the depository institution does not reserve the right to require at least seven days' written notice of an intended withdrawal."[9] DDAs are defined in contrast to[10] "NOW accounts" (deposits of individuals and certain qualified entities "on which the depository institution has reserved the right to require at least seven days' written notice prior to withdrawal or transfer of any funds in the account"),[11] "savings deposits" ("a deposit or account with respect to which the depositor is not required by the deposit contract but may at any time be required by the depository institution to give written notice of an intended withdrawal not less than seven days before withdrawal is made, and that is not payable on a specified date or at the expiration of a specified time after the date of deposit")[12] and "time deposits" (a "deposit that the depositor does not have a right and is not permitted to make withdrawals from within six days after the date of deposit unless the deposit is subject to an early withdrawal penalty of at least seven days' simple interest on amounts withdrawn within the first six days after deposit).[13] In short, DDAs are deposits that are not subject to seven-day discretionary gating by the bank or early redemption fees, while other deposits are subject to discretionary gating or a contractual maturity period at least seven days in the future, and/or early redemption fees.

The percentage of bank deposits that are *not* subject to withdrawal deferrals or early withdrawal fees under Regulation D (*i.e.*, DDAs alone) is fairly small. As a whole, the FFIEC peer group data as of December 31, 2013 on "Peer Group 1" – large banks with over $3 billion in deposits –as percentages of total assets (and of bank funding), indicate that on average less than nine percent of total deposit balances in large US banks are in DDAs. The rest of bank deposits are subject to Regulation D gates and fees.[14]

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[9] 12 C.F.R. § 204.2(b)(1).

[10] 12 C.F.R. § 204.2(b)(3).

[11] 12 C.F.R. § 204.2(b)(3)(ii).

[12] 12 C.F.R. § 204.2(d)(1).

[13] 12 C.F.R. § 204.2(c)(1)(i). Notably, once the seven day notice has been required and given or the time deposit is within seven days of maturing, it is deemed to be a DDA. 12 C.F.R. § 204.2(b)(1)(vii).

[14] Federal Financial Institutions Examination Council, *Uniform Bank Performance Report -- Peer Group Average Reports* (data as of December 31, 2013), *available at* https://www.ffiec.gov/ubpr.htm. The deposit

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According to FFIEC data for the large banks, DDA account balances average 7.00% of total bank assets, NOW and ATS accounts average 2.17% of total assets, money market deposit accounts ("MMDAs") average 33.60% of total assets, other savings accounts average 12.78% of total assets, time deposits average 25.50% of total assets, and all deposits in total average 79.05% of assets at the large "Peer Group 1" banks with over $3 billion in deposits. According to the FDIC's 2013 Annual Report, approximately 61% of all U.S. bank deposits are fully insured.[15] If deposits comprise 79% of liabilities of U.S. banks, and only 61% of those deposit are insured, approximately 52% of funding of U.S. bank assets is provided either by deposits in excess of FDIC insurance limits or by instruments that are not deposits and therefore not eligible for FDIC insurance.

Interestingly, if the FRBNY Staff Gates & Fees Paper were correct, the existing requirement that banks reserve the right to impose early withdrawal fees on time deposits or simply refuse early withdrawal requests from time deposits, and to reserve the right to defer for seven days requests for withdrawals from savings accounts, and thereby limit withdrawal of all deposits other than DDAs, which together represent roughly 91% of large bank deposits, should trigger preemptive runs on banks.

Read literally, the FRBNY Staff Gates & Fees Paper proves too much. Essentially it suggests that Section 19 of the Federal Reserve Act and Federal Reserve Regulation D, by authorizing banks to impose gates and fees in respect of the vast majority of their deposits, encourage preemptive runs on banks and thereby create systemic risk and instability. Yet the FRBNY Staff Gates & Fees Paper does not provide any evidence that the existing limited short-term discretionary redemption gates and fees authority (which has been in place since 1913 at banks in the U.S. pursuant to Section 19 of the Federal Reserve Act and Regulation D and since 1940 at U.S. mutual funds pursuant to Section 22(e) of the Investment Company Act) has ever triggered preemptive

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figures in the UBPR peer group reports are average percentages of total bank assets (and therefore of funding of those assets) in certain categories of data tracked by FFIEC.

[15] Data appendix to the FDIC 2013 Annual Report at 3 (Mar. 14, 2013), *available at* http://www.fdic.gov/about/strategic/report/2013annualreport/AR13appendix.pdf. The percentage of insured deposits may be smaller at the largest banks.

runs at banks or MMFs.[16] Instead, the authors simply assume that U.S. banks and MMFs have never had any redemption gate or fee authority.

Regulation D and its statutory underpinnings are a cornerstone of the Federal Reserve Act and are fundamental to the way in which the Federal Reserve has regulated commercial bank liquidity and funded its own operations for over 100 years. The middle word in "Federal *Reserve* Act," "Federal *Reserve* Bank" and "Federal *Reserve* System" is drawn from the title of the statutory and regulatory sections that impose gates and fees on all bank deposits other than DDAs, demonstrating how central these provisions are to how the Federal Reserve System of banking regulation operates. Surely three Federal Reserve staff economists and one former Federal Reserve Bank visiting scholar could not be completely ignorant of the organic statute and regulations of their employer.

Perhaps, instead, the authors of the FRBNY Staff Gates & Fees Paper are informed on these matters but concluded that if discretionary gates are sufficiently short in maximum duration and applied very infrequently (the seven days notice requirement in Regulation D) and if early redemption fees are sufficiently small (a loss of seven days interest as required by Regulation D on time deposits), gates and fees will not trigger preemptive redemptions or otherwise prove destabilizing to the financial system. If this is the case, we find some common ground with the FRBNY Staff Gates and Fees Paper. As the Commission is aware, Federated has suggested that Alternative Two be modified to shorten the potential maximum discretionary gating period to ten days (from 30 in the proposal) and set a lower potential redemption fee. Redemption gates and fees at these more appropriate levels, applied only rarely, are entirely consistent with longstanding requirements applicable to banks.

In Federated's view, only the Commission's proposed Alternative Two would achieve the Commission's stated reform goals while promoting efficiency, competition, and capital formation and satisfying the Commission's own internal guidelines for

[16] Section 22(e) of the Investment Company Act currently provides limited gating authority by permitting MMFs to defer payment on redemptions for up to seven days with or without cause, and to suspend temporarily on a discretionary basis redemptions if the NYSE is closed or portfolio prices are unavailable, or if the Commission issues an order based on the existence of an emergency. Alternative Two, as proposed by Federated to be modified to shorten the maximum discretionary gating period to ten days (down from 30 in the proposal) is a modest extension of the existing limited gating authority.

economic analysis[17] (provided that the critical modifications suggested by Federated in other letters to the Commission are adopted).[18] Implementing the Commission's Alternative One (the "floating NAV" proposal) either by itself or in conjunction with Alternative Two, would fail to achieve the Commission's reform goals while imposing costs on investors, funds, and the economy as a whole that far outweigh any benefits, thereby contravening the Commission's statutory obligations and the Commission's guidance.

We appreciate the opportunity to provide comments on the Release.

Sincerely,

David. F. Freeman, Jr.

[17] Division of Risk, Strategy, and Financial Innovation and Office of General Counsel, *Current Guidance on Economic Analysis in Commission Rulemakings* (Mar. 16, 2012), *available at* http://www.sec.gov/divisions/riskfin/rsfi_guidance_econ_analy_secrulemaking.pdf ("Guidance").

[18] 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 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 Two 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 interest of shareholders. Federated also recommended exempting tax exempt fund from the liquidity fee and temporary suspension requirements, if Alternative Two is adopted.