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May 14, 2014

The Honorable Mary Jo White
Chair
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 — Concluding Comments Regarding the Commission's Proposed Rule on Money Market Fund Reform

Dear Chair White:

We are writing on behalf of our client, Federated Investors, Inc. and its subsidiaries ("Federated"), to provide concluding comments concerning the Securities and Exchange Commission's ("Commission's") rulemaking file on money market fund ("MMF") reform.[1] The stated goal of the rulemaking is to address the Commission's concerns about the potential for large-scale redemptions from MMFs during a period of financial stress or in response to a significant credit event at a MMF.[2] The Commission in its Release and Chair White in public statements have assured investors that the Commission seeks to preserve the benefits of MMFs for investors.[3] The question confronting the Commission as it moves toward adoption or reproposal is whether these two goals can be reconciled in a manner consistent with the Commission's obligations in conducting rulemakings.

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[1] *Money Market Fund Reform; Amendments to Form PF*, 78 Fed. Reg. 36834 (June 19, 2013) ("Release"). This letter supplements earlier letters filed by and on behalf of Federated which discussed specific elements of the Release. Those prior letters are available in the Commission's File No. S7-03-13.

[2] Release at 36834.

[3] *Id.* at 36836 ("Each alternative seeks to preserve the ability of money market funds to function as an effective and efficient cash management tool for investors . . . ."); Chair Mary Jo White, Speech to the Investment Company Institute: Regulation in a Global Financial System (May 1, 2013) ("As the SEC works to develop and propose meaningful money market fund reform, our goal is to preserve the economic benefits of the product while addressing potential redemption pressures and the susceptibility of these funds to runs . . . .").

The data, studies, and commentary in the Commission's extensive comment file point to a clear answer: Give due consideration to the comments, follow the facts, and insist upon a data-driven, cost-effective rule that best provides the benefits the Commission seeks to achieve, including, especially, the protection of investors.

There is no question that authorizing MMF boards in rare and limited circumstances to temporarily halt redemptions for periods of short duration will stop a run. Forcing prime MMFs to float their net asset values ("NAVs") will not.

Importantly, a tailored gates and fees proposal will preserve the day-to-day utility of MMFs for investors. Forcing investors to redeem at a fluctuating NAV will not.

As the overwhelming comments, surveys, data, and other materials in the comment file make clear, adopting a limited gates and fees rule will fulfill the Commission's articulated rulemaking objectives; imposing a floating NAV will not.

Moreover, after reviewing the great weight of the evidence in the comment file, it also is clear that the Commission cannot reach a decision to impose both a floating NAV and gates/fees in combination on certain MMFs; commenters are clear that the combination would make those funds a product no rational investor would ever buy and would "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."[4]

The Commission and its rule writers are well aware of the Commission's obligations under the Administrative Procedure Act, the Investment Company Act of 1940 and other Federal laws, the holdings of federal courts regarding applicable statutory requirements, as well as the Commission's own binding rulemaking guidance ("Guidance").[5] Those obligations compel the Commission to consider the protection of

[4] Letter from Wells Fargo Funds Management to Commission (Sept. 16, 2013) (Available in File No. S7-03-13). Comments available in the Commission's Comment File No. S7-03-13 generally are cited in this letter by reference to the name of the commenter (*e.g.*, "Wells Fargo"). For clarity, letters filed by or on behalf of Federated are cited by date and, where applicable, title.

[5] *See* National Securities Market Improvement Act of 1996, Pub. L. No. 104-290, § 106; Investment Company Act of 1940, § 2, 15 U.S.C. § 80a–2; Regulatory Flexibility Act, 5 U.S.C. § 601 *et seq.*; Small

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investors and the impact of the various alternatives on efficiency, competition, and capital formation. They further require the Commission to weigh the benefits and costs of alternatives and make cost-effective regulatory choices. The Commission cannot meet those obligations if it arbitrarily chooses a regulatory alternative that, according to the overwhelming weight of commentary, data, studies, and other evidence in the comment file, costs the most but does the least in terms of accomplishing the Commission's objectives. Indeed, the Commission will violate those requirements if it makes a regulatory choice that would destroy a product for a large segment of investors, when a far less disruptive alternative that better achieves its regulatory goals, better protects investors, and preserves the product is available.[6]

I. Imposing a floating NAV on institutional investors does not achieve the Commission's stated regulatory goals, imposes far greater costs and burdens on investors and market participants than other alternatives, and negatively impacts efficiency, competition, and capital formation.

The floating NAV does not prevent or mitigate run risk in a crisis. The overwhelming number of comments in the Commission's current comment file (as well as comments filed in other dockets over the past three years) from MMF users, service

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Business Regulatory Enforcement Fairness Act of 1996, 5 U.S.C. §§ 801, 804; 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"); *Business Roundtable v. Commission*, 647 F.3d 1144 (D.C. Cir. 2011); *Am. Equity Inv. Life Ins. Co. v. Commission*, 613 F.3d 166 (D.C. Cir. 2010); *Chamber of Commerce v. SEC*, 412 F.3d 133 (D.C. Cir. 2005). *See also Nat'l Asso. of Manufacturers v. Commission*, No. 13-5252 (D.C. Cir. Apr. 14, 2014) (This case is further discussed in n.45 of this letter). *See also* Letter from Arnold & Porter LLP to Commission at 2-11 (Sept. 17, 2013) (Available in File No. S7-03-13) (letter titled "Costs of the Proposals" discussing in detail the Commission's legal obligations in rulemakings).

[6] In this regard, we note that the floating NAV proposal was promoted by the Commission's former chair, supported by the Federal Reserve (which has a more than 30-year record of hostility to MMFs) and has remained an element of MMF reform proposals by the Financial Stability Oversight Council ("FSOC") and by the Commission in the current rulemaking. Although the Commission's staff diligently has worked in an effort to build a case for this desired outcome, the Commission now must confront the fact that the record simply does not support it.

providers, academics and analysts, and most fund sponsors 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.[7] Data from the financial crisis showing that investors ran from floating NAV funds in Europe and ultra-short bond funds in the U.S. provides a real-world example of investor behavior.[8] Although the Commission's Release speculated that a floating NAV "*could* alter investor expectations," and that investors therefore "*should* become more accustomed to, and tolerant of," fluctuations in MMF NAVs, and that investors therefore "*may be* less likely to redeem shares in times of stress,"[9] there is no data in the comment file or the Release to support what is merely the Commission's predictive judgment. Indeed, the majority of commenters who address this issue reject the Commission's theory,[10] and the

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[7] *See, e.g.*, U.S. Bancorp (a floating NAV "completely fails to address MMF run risk."); National League of Cities; Independent Directors Council; Invesco; Dreyfus; Fidelity; BlackRock; ICI. Many of these comments are summarized in our letter filed November 21, 2013. Letter from Arnold & Porter LLP to Commission (Nov. 21, 2013) (Available in File No. S7-03-13). Both the Release and a previous study from the Division of Risk, Strategy and Financial Innovation discuss potential consequences of a portfolio credit loss followed by large-scale shareholder redemptions (25% – nearly twice as large as the 14% experienced by prime funds overall during the week of September 15, 2008) to a hypothetical MMF's NAV. The Release posits that this situation could cause the MMF to "break the buck." The Release does not explain, however, how a floating NAV would change that outcome (it would not). Moreover, the Release incorrectly assumes that the NAV of a MMF can never recover from a portfolio credit loss. In the short run, the redemption fee authorized by Alternative Two could increase the NAV of the MMF in the hypothetical described in the Release back to $1 per share; in the longer term, MMF portfolio managers can and do realize gains on sales of portfolio assets and over a period of time can replace realized losses from portfolio assets with realized gains to similarly bring the NAV back to $1 per share. A temporary suspension of redemptions would stop the redemptions outright. *See* Release at 36837-38, 36844; Division of Risk, Strategy and Financial Innovation, Response to Questions Posed by Commissioners Aguilar, Paredes, and Gallagher (Nov. 30, 2012), *available at* http://sec.gov/news/studies/2012/money-market-funds-memo-2012.pdf ("RSFI Study"). Of course, MMF shares are *not* insured and *may lose value* – facts which decades of prominent disclosure and the experience of investors in the Reserve Fund make abundantly clear.

[8] *See, e.g.*, HSBC, UBS, Wells Fargo, Virginia Treasurer. *See* Letter from Arnold & Porter LLP to Commission Appx. 2-6 (Nov. 21, 2013) (Available in File No. S7-03-13) (listing and summarizing comment letters on this point); *See also* Letter from Arnold & Porter LLP to Commission at 5-6 (Sept. 13, 2013) (Available in File No. S7-03-13) (letter titled "Problems with a Floating NAV").

[9] Release at 36851 (emphasis added).

[10] *See, e.g.*, U.S. Bancorp, Independent Directors Council, UBS, Wells Fargo, BlackRock, ICI, Silicon Valley Bank, Sungard. Arnold & Porter's November 21, 2013 letter on behalf of Federated quoted from 19

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Commission itself has conceded 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."[11] The Commission has acknowledged, however, in contrast, that "[G]ates are the one regulatory reform in this Release . . . that definitely stops a run on a fund (by blocking all redemptions).").[12]

A floating NAV is an unnecessary and excessively burdensome means of communicating MMF risks to institutional investors. Moreover, a floating NAV is a wholly unnecessary means to communicate what investors – particularly institutional prime MMF investors who are the target of the Commission's proposed floating NAV reform – already know, that the underlying fair value of a MMF portfolio fluctuates and that a MMF may lose value. Here, the Commission has a very stark cost-benefit calculation to make in choosing among regulatory alternatives designed to inform investors of the risk of investing in MMFs. It can choose to impose multi-billion dollar costs on institutional investors, fund sponsors and intermediaries, to overhaul and convert systems to accommodate an NAV that fluctuates, based upon mark-to-model fair valuations, to the fourth decimal point – for the benefit of informing institutional investors of facts they already know.[13] In the alternative, if the Commission concludes that there are marginal benefits in providing more information to investors, it could

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letters and cited an additional 27 letters rejecting the Commission's theory. Treasury Strategies on March 31, 2014 filed a detailed analysis applying game theory concepts modeling rational decision-making by economic agents in the face of uncertainty to investor behavior in floating NAV funds during crisis periods. Treasury Strategies concludes that a floating NAV would neither prevent a run from happening nor stop a run in progress.

[11] Release at 36851.

[12] *Id.* at 36880.

[13] As Sungard commented, "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." *See also* ICI, Silicon Valley Bank, George Mason University Mercatus Center, American Bar Association, Independent Directors Council, J.P. Morgan, Committee on Capital Markets Regulation, Wells Fargo.

choose the more cost-effective approach of requiring daily mark-to-model NAV disclosure (which is already provided by many funds), additional portfolio disclosure and other enhanced disclosures as proposed in the Commission's rulemaking.[14] Of course, if the Commission chooses to adopt the gates/fees alternative (the most effective alternative to address run risk), the accompanying disclosures will make clear to investors that MMFs are subject to the risk of temporary loss of liquidity or redemption fees.

Moreover, the Commission has not provided any basis, apart from creating arbitrary and trivial fluctuations in the share price, for requiring MMFs to calculate their NAV to the nearest basis point for shareholder transactions, when all other mutual funds are held to only a ten basis point standard of valuation. Even MMF managers who expressed qualified support for Alternative One objected to requiring their funds to transact at a four decimal place NAV.[15] The Investment Company Act of 1940 authorizes the Commission to regulate the NAV of redeemable securities only for "the purpose of eliminating or reducing so far as reasonably practicable any dilution of the value of other outstanding securities of such company or any other result of such purchase, redemption, or sale which is unfair to holders of such other outstanding securities . . . ."[16] The Release did not articulate any risk of dilution or other unfair results unique to MMFs that would require a different standard of valuation for their NAVs. Furthermore, nothing in the Release or comment file justifies the abandonment of amortized cost method of valuing MMF portfolios – a method MMF boards may use under Rule 2a-7 *only* if it fairly represents market-based valuation.[17]

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[14] Federated's letter dated September 17, 2013 discusses appropriate additional disclosures in greater detail. Letter from Federated to Commission (Sept. 17, 2013) (Available in File No. S7-03-13) (letter titled "Comments Regarding Amendments to Disclosure Requirements for Money Market Funds and Current Requirements of Rule 2a-7").

[15] *See, e.g.*, Schwab. A number of other MMF managers, including Dreyfus, Fidelity, Invesco, Goldman, J.P. Morgan, and Blackrock, argued strongly that the proposal for basis point pricing was unjustified. *See* 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."

[16] Investment Company Act of 1940 §22, 15 U.S.C. § 80a–22.

[17] 17 C.F.R. § 270-2a-7(c)(1) ("The . . . money market fund will continue to use such [amortized cost] method only so long as the board of directors believes that it fairly reflects the market-based net asset value per share."). As the Commission is aware, the stable value pricing of MMFs using the amortized cost method closely tracks "market-based" valuations derived from pricing services' mark-to-model valuations.

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The billions of dollars of costs associated with a floating NAV cannot be justified. The Commission concedes that a floating NAV will have a more disruptive effect than gates and fees, stating in the Release that "investors may withdraw more assets under the floating NAV proposal than they would under the liquidity fees and gates alternative because the floating NAV proposal may have a more significant effect on investors' day-to-day experience with and use of money market funds than the liquidity fees and gates alternative and because many investors place great value on principal stability in a money market fund."[18] Comments in the file support this view.[19]

The costs of the Commission's floating NAV proposal are enormous.[20] The Commission's Release acknowledged that the operational burdens of overhauling the complex software and other systems of large institutional investors, intermediaries, transfer agents, and fund sponsors will be substantial.[21] The Release further acknowledged concerns regarding the burdens associated with the tax and accounting treatment of MMF transactions at a floating NAV, but neither the Commission nor other regulators have solved these issues in the intervening period.[22] These costs, burdens, and

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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. This promotes efficiency while protecting investors.

[18] Release at 36915.

[19] *See, e.g.*, Dreyfus, Fidelity, U.S. Bancorp, Silicon Valley Bank, Cleco Corporation, BlackRock, Sungard.

[20] *See, e.g.*, Government Finance Officers Association, American Benefits Council, Committee on Capital Markets Regulation, Boeing, American Bankers Association. *See also* Letter from Arnold & Porter LLP to Commission 24-31, 35-43 (Sept. 13, 2013) (Available in File No. S7-03-13) (letter titled "Problems with a Floating NAV").

[21] *See, e.g.*, Release at 36870. DST, State Street, and Sungard, among others, filed detailed comments explaining the operational challenges of accommodating a floating NAV.

[22] Under current law, *de minimis* gains and losses from floating NAV MMF transactions would be subject to IRS reporting requirements, a particularly burdensome requirement for institutional investors that are generally exempt from receiving annual tax information from funds, and thus would be responsible for tracking, calculating, and reporting gains and losses. A true fix would require Congressional modifications to the basic gain and loss tax regime, which has not been forthcoming. *See* Letter from Hunton & Williams LLP on behalf of Federated to Commission (May 1, 2014) (Available in File No. S7-03-13). Floating
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uncertainties damage the essential features of MMFs that make them useful to investors as a cash management product (and to issuers in providing working capital to finance operations), and investors will seek out alternative investment products rather than incur the resulting costs.[23]

The costs of the floating NAV proposal go beyond the calculable operational, tax and other burdens. The file contains comment letters addressing the risks and inefficiencies in the form of settlement bottlenecks and delays for investors and intermediaries, new risks from potential technology breakdowns and systems failures at the pricing vendors responsible for supplying intraday portfolio valuations, and potential systemic risks on payment systems and markets.[24] Commenters also warned that reducing or eliminating the utility of MMFs for investors will contract the market for, and raise the costs of, short-term public and private financing, forcing issuers to pay higher interest, extend the duration of their debt burdens, and/or resort to bank lending on less favorable terms as a result.[25] The Commission's file also contains significant

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NAV transactions would also be subject to the IRS's "wash sale" rule, which, even if made inapplicable below certain thresholds, would still impose a substantial recordkeeping burden on shareholders (which must continue to track losses in the event that any were to exceed the proposed guidance's threshold). Recognizing the importance of these issues to investors, one Commissioner stated that his support of any floating NAV proposal was contingent on the Commission "fully understanding and addressing" the tax and accounting issues that could arise, which the Commission has not accomplished to date. Joshua Gallu and Robert Schmidt, *SEC's Gallagher Calls for Floating Price for Money Funds*, Bloomberg, Sept. 27, 2012, available at http://www.bloomberg.com/news/2012-09-27/sec-s-gallagher-calls-for-floating-price-for-money-market-funds.html.

[23] In addition, many institutional and public sector commenters expressed concern that legal or investment restrictions may prevent them from investing in floating NAV MMFs. Those commenters included Chicago Treasurer, Government Finance Officers Association and other public sector signatories, American Benefits Council, American Bankers Association, and Association for Financial Professionals. Letter from Arnold & Porter LLP to Commission Appx. 11 (Nov. 21, 2013) (Available in File No. S7-03-13).

[24] SIFMA, ICI, Sungard, and DST, among others, raised concerns with respect to same-day settlement in their comment letters to the Commission. *See also* Letter from Arnold & Porter LLP to Commission 20-22 (Sept. 13, 2013) (Available in File No. S7-03-13) (letter titled "Problems with a Floating NAV" discussing risks related to pricing vendors); Letter from Arnold & Porter LLP to Commission Appx. 19-20 (Nov. 21, 2013) (Available in File No. S7-03-13).

[25] *See* U.S. Chamber of Commerce, ICI, Association for Financial Professionals, and National Association of State Auditors, Comptrollers and Treasurers, among others discussing these issues.

commentary describing the floating NAV's negative effect on efficiency, competition, and capital formation by lowering yields for investors and raising costs for users and issuers.[26]

For these reasons, 1,390 of the 1,410 commenters who addressed the issue voiced direct opposition to or raised serious concerns regarding the floating NAV proposal.[27]

II. Voluntary gating and enhanced disclosures achieve the Commission's regulatory goals, protect investors, and promote efficiency, competition and capital formation while preserving MMFs as a viable cash management tool.

A tailored gates and fees approach achieves the Commission's reform goals. The effectiveness of the gates and fees alternative in achieving the Commission's goals, and its lower comparative costs, stand in stark contrast to the Commission's floating NAV proposal. A gates and fees alternative will protect against runs (gates), avoid the potential dilutive effect of heavy redemptions (fees), preserve MMFs as a viable cash management product and avoid the floating NAV's negative effects on efficiency, competition, and capital formation.

The weight of comments that addressed the Commission's gates and fees proposal agreed with the Commission's own assessment that where a MMF is facing the threat of heavy redemptions or another event that could result in material dilution or unfair results to shareholders, a temporary suspension of redemptions is the one regulatory reform in

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[26] *See* comments of Chamber of Commerce, ICI, National Association of State Auditors, Comptrollers and Treasurers, Virginia Treasurer and the St. Louis Treasurer, among others discussing these issues, cited in our November 21, 2013 letter. Letter from Arnold & Porter LLP to Commission Appx. 43-50, 52-55, 62-68 (Nov. 21, 2013) (Available in File No. S7-03-13).

[27] 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 nineteen letters filed by or on behalf of Federated as one letter or commenter, as appropriate.

the proposal that would stop a run.[28] In the words of Commissioner Gallagher, a gate would "ensure that a run is stopped in its tracks . . . ."[29]

Here, the Commission also can look to experience from the financial crisis. On September 18, 2008, the board of directors of the U.S. Putnam Institutional Prime Money Market Fund – confronted with heavy redemptions that could have led to material dilution and unfair results to its shareholders – voted to suspend redemptions and liquidate the fund, allowing the board sufficient time to negotiate a solution. The fund's assets and investors were transferred to another fund managed by Federated, in a process so smooth that investors were able to redeem within seven days without investment loss. *Investors benefited significantly from the Putnam board's action*. Federated's experience has led it to advocate for a regulatory change allowing MMF boards, under those rare circumstances when investors are at risk of material dilution, to gate a MMF and provide its board time to look for a solution, without liquidating the fund as required under current Commission rules.

A paper filed with the Commission by Hester Pierce and Robert Greene from the George Mason University Mercatus Center provides research and data regarding the historical use and effectiveness of gating in sectors other than MMFs.[30] Pierce and Green argue that the Commission's proposal should be modified to give MMF boards discretion to freeze redemptions whenever and for as long as they determine is in the best interests of the fund. They argue that this "would entrust boards with a responsibility that is consistent with other responsibilities they exercise, would serve as a stark reminder to

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[28] *See e.g.*, Independent Directors Council, Deutsche, Dreyfus, Fidelity, ICI, State Street, Independent Trustees/Federated Funds, U.S. Bancorp.

[29] Daniel M. Gallagher, *Statement at the SEC Open Meeting on Money Market Fund Reform* (June 5, 2013), *available at* http://www.sec.gov/news/speech/2013/spch060513dmg.htm. *See also* Release at 36880 ("[G]ates are the one regulatory reform in this Release . . . that definitely stops a run on a fund (by blocking all redemptions).").

[30] Letter from George Mason University Mercatus Center to Commission (Apr. 8, 2014) (Available in File No. S7-03-13). Pierce and Greene cite other research finding that gates mitigated the severity of runs on U.S. commercial banks in the early 1900s: "[R]edemption restrictions protected the banking system, ensured that the failure of banks did not set off a chain reaction, provided distressed banks with the time to raise adequate liquidity, and 'gave time for the immediate panic to wear off.'" *Id.* at n.297. The Pierce/Greene paper further observes that gates have been effective in preventing runs in hedge funds, noting that by December 2008 "roughly 100 hedge funds had imposed restrictions on withdrawals." *Id.* at 43.

investors that MMFs are not equivalent to bank accounts, and would give MMF advisers, boards and investors an incentive to limit MMF risk-taking in order to safeguard ready redeemability.[31]

Federated believes the Commission's rulemaking file currently does not support giving MMF boards the authority to impose a gate without limits. But, given the effectiveness of a gate in protecting shareholders and preserving assets of a MMF in the event of extreme stress, we believe it is incumbent upon the Commission to give MMF boards sufficient discretion to impose a gate intra-day when necessary to protect shareholders, particularly to pre-empt a run. Indeed, as discussed below, we believe the concerns voiced by a small number of commenters concerning the potential threat of preemptive runs could be addressed by such a modification of the proposal and that the rulemaking docket does support this change. Moreover, as discussed above, prominent disclosure of the possibility of a liquidity fee or gate will also serve to underscore that MMFs are not a risk-free investment.

Alternative Two is the more cost-effective option. Commenters have argued that, not only are gates effective, but that the gates and fees alternative is the only alternative that could be implemented in a cost effective manner, that would preserve the utility and day-to-day operational efficiency of MMFs for investors and that, as a result, would maintain MMFs as a source of short-term financing for corporate and governmental issuers.[32]

Alternative Two must be modified to ensure its effectiveness. A total of 1,266 of 1,341 letters that addressed Alternative Two supported the approach, in some cases with proposed modification. Federated has proposed modifications that would enable the proposal to better achieve its goals.

A small number of commenters argued that the proposal could lead to preemptive runs by investors who closely monitored a MMF as it approached a gate or fee trigger.[33] While earlier commenters provided no data on this point, the Federal Reserve Bank of

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[31] *Id.* at 4.

[32] Commenters on these issues included Independent Directors Council, Wells Fargo, Deustche, Fidelity, George Mason University Mercatus Center (Apr. 8, 2014).

[33] Those commenters included the Mutual Fund Directors Forum, Federal Reserve Banks, Kentucky Treasurer, Americans for Financial Reform, Systemic Risk Council.

New York staff (FRBNY) recently filed a report which they argue supports the view that allowing financial intermediaries to impose redemption fees or gates in a crisis can lead to preemptive runs.[34] But the key assumption underlying the FRBNY's entire analysis, that banks are currently prohibited from imposing gates or fees on redemptions, is demonstrably false. Other than demand deposit accounts, which constitute less than 9% of large bank deposits, 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. Thus, if the authors' conclusion were correct, one would expect to see preemptive runs on banks. Indeed, given its flawed premise, we are not surprised that, as the study acknowledges, its conclusion "contrasts with the existing literature . . . ."[35]

Federated nonetheless shares the concerns of certain commenters regarding proposed Alternative Two as drafted, and has recommended that the Commission make modifications to Alternative Two in order for the gating and liquidity fee tools to operate effectively and to minimize their potential impact on shareholders.[36] The modifications Federated proposed include: (1) reducing the 15% threshold for weekly liquid assets to 10%; (2) reducing the maximum temporary suspension period to 10 days; and (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.[37] If the Commission carefully crafts Alternative Two and makes it clear in any adopting release that the purpose of the

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[34] 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 ("FRBNY Staff Report"). *See also* Release at 36881, n.361 (citing a January 8, 2013 letter from Professors Samuel Hanson, David Scharfstein, and Adi Sunderam, Harvard Business School to FSOC).

[35] FRBNY Staff Report at 3.

[36] *See* Letter from Federated to Commission (Sept. 16, 2013) (Available in File No. S7-03-13) (letter titled "Comments Regarding Proposed Alternative 2").

[37] Federated also urged the Commission to exempt tax exempt MMFs from the gates/fees provisions, as the proposal does for government MMFs.

provision is to protect, and not to penalize, shareholders and that it expects boards to impose liquidity fees or suspensions of redemptions rarely and only for so long as necessary to protect the interests of shareholders, there will be far less likelihood of preemptive redemptions, and greater shareholder acceptance of this alternative and a diminished effect of MMF shareholders exiting MMFs.

The record does not support the adoption of Alternatives One and Two in combination. Commenters who addressed the potential adoption of Alternatives One and Two in combination were nearly uniform in explaining that such a product would not be viable.[38] As the Commission acknowledges, gates are the only alternative under consideration that effectively stops a run. Given the documented costs and burdens of the floating NAV, there is no justification for applying the floating NAV in addition to gates and fees: It will have no effect in further mitigating run risk; it will not inform institutional investors of anything they do not already know; it will negatively impact efficiency, competition, and capital formation. The combination will only serve to destroy the utility of MMFs for investors. The Commission cannot justify its adoption.

III. The existing record does not support adoption of Alternative One given the Commission's Guidance and other legal obligations. The record does support the adoption of a modified version of Alternative Two as the more cost-effective means of achieving the Commission's reform goals.

The Commission has a choice between regulatory alternatives. The Commission's Release contained 163 pages of economic analysis, predictive judgments, and other commentary, and the comment file has been open for eleven months and has collected comments from more than 1,400 investors, intermediaries, fund sponsors, academics, and other interested parties and contains even more analysis and information on the proposals and the potential impact of each. We have commented extensively on the problems associated with the Commission's proposal and have carefully reviewed the other comments. We have carefully reviewed the Commission's own analysis and studies, including both the most recent papers from the Commission's Division of

[38] *See, e.g.*, Invesco, Dreyfus, Fidelity, Oppenheimer, Wells Fargo, BlackRock, Goldman, SIFMA, ICI, State Street.

Economic and Risk Analysis ("DERA"),[39] and its earlier staff analysis which concluded that while the 2010 amendments provided beneficial enhancements more could be done to enhance MMF resiliency.[40] Importantly, none of the Commission's own studies support a conclusion that movement to a floating NAV would prevent runs or make MMFs more resilient.

Neither the Commission's commentary in support of Alternative One nor the comment file itself contains the necessary facts or analysis to support a final rule adopting a floating NAV alone or in combination with gates and fees.

The Commission's Guidance states the Commission must consider "whether . . . alternatives are better or worse (in terms of achieving the regulatory purpose in a cost-effective manner) than the proposed rule."[41] The alternatives proposed in the Commission's proposed rule, viewed in this context, could not present a clearer choice.

A fundamental question is how well either Alternative will work to deter, prevent and stop shareholder runs from MMFs in a time of crisis. That is, after all, the stated problem that this rulemaking is intended to solve. The administrative record documents ample basis to conclude that Alternative Two will be effective at stopping shareholder runs, particularly when combined with the robust portfolio liquidity, high credit quality and transparency that have been required by the 2010 amendments to Rule 2a-7. The administrative record contains essentially nothing other than the naked assertions of the Federal Reserve and a handful of others that Alternative One (floating NAV) will deter, stop or even slow down shareholder runs on MMFs during a crisis. Indeed, not even the Federal Reserve appears to believe that Alternative One will have that desired effect. A

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[39] DERA added four memoranda to the comment file on March 17, 2014. The memoranda are titled *Demand and Supply of Safe Assets in the Economy, Municipal Money Market Funds Exposure to Parents of Guarantors, Government Money Market Fund Exposure to Non-Government Securities*, and *Liquidity Cost During Crisis Periods*. We and Federated have provided views regarding several of these four memoranda. Letter from Arnold & Porter LLP to Commission (Apr. 23, 2014); Letter from Federated to Commission (Apr. 23, 2014). DERA also submitted a study titled *The Economic Implications of Money Market Fund Capital Buffers* on January 24, 2014 regarding the inability of capital buffers to absorb large-scale defaults while maintaining the investor returns necessary to ensure a viable investment product.

[40] RSFI Study. Federated previously provided comments on the report. Letter from Federated Investors to Commission (Jan. 7, 2013).

[41] Guidance at 8.

2012 report by FRBNY staff conceded that "investors in an MMF with a floating NAV would still face strong incentives to redeem shares quickly at the first sign of trouble . . . ."[42] If there is an insufficient record for the Commission to conclude that Alternative One will be effective in stopping runs on MMFs, there is no basis for adopting Alternative One.

The implementation costs and negative economic impact of imposing a floating NAV on institutional prime MMFs are severe, and a floating NAV ultimately would fail to achieve the Commission's stated reform goals. In contrast, the gates and fees alternative (which should be modified to address commenters' concerns), would achieve the Commission's goals and could be implemented in a far less costly manner.

Members of the Commission have previously stated that a solution by the U.S. Treasury of the tax issues associated with Alternative One is a prerequisite to the Commission adopting Alternative One. As of this date, the tax issues have not been resolved and indeed no solution has even been proposed or openly discussed by Treasury.[43] Until that prerequisite – which implicates one part of the costs and burdens of Alternative One on MMFs investors and hence the impact on efficiency and capital formation – has been met through adoption and implementation by Treasury of a complete resolution of the tax problems, Alternative One cannot be adopted by the Commission. Even if that condition could be met, imposing a floating NAV on institutional MMFs would require significant expenditures to retool systems, would generate settlement delays and other risks commenters have previously addressed, and would remain the alternative that costs the most but does the least in achieving the Commission's regulatory goals.

Authorizing MMF boards to impose gates and fees provides a benefit to investors and other affected parties by achieving the Commission's regulatory purposes in a cost-effective manner; will not unduly impact efficiency, competition, and capital formation;

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[42] Patrick E. McCabe, et al., *The Minimum Balance at Risk: A Proposal to Mitigate the Systemic Risks Posed by Money Market Funds*, Federal Reserve Bank of New York Staff Study No. 564 at 1 (July 2012), *available at* http://www.federalreserve.gov/pubs/feds/2012/201247/201247pap.pdf.

[43] *See* Letter from Hunton & Williams LLP on behalf of Federated to Commission (May 1, 2014) (Available in File No. S7-03-13).

and will preserve the day-to-day utility of MMFs for investors.[44] While Alternative One appears to be unsupported by the administrative record and beyond the discretion afforded to the Commission by its statutory obligations, a modified version of Alternative Two could satisfy the Commission's legal obligations and binding Guidance.[45]

As the comparative analysis of cash alternatives to MMFs in the Commission's Release demonstrates, MMFs provide a combination of stability, transparency, low risk, liquidity, competitive yield and regulatory oversight that is unmatched by alternative products.[46] It therefore is no surprise that, in the years since the financial crisis, $2.6 trillion have remained in MMFs despite a near-zero interest rate environment. Investors have spoken: MMFs are good for investors. They are a useful product that should be preserved.

The Commission's need to choose a regulatory alternative that preserves MMFs for investors further is compelled by the statutory obligation to consider the effects of its

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[44] As described above, because Alternative Two achieves the Commission's stated reform goals, there is no incremental benefit to combining Alternatives One and Two as proposed in the Release. In any event, with the adoption of reasonable enhanced disclosures, the Commission could monitor the effectiveness of Alternative Two and reserve implementation of other proposals in the unlikely event that these reforms prove inadequate.

[45] We note in this regard that courts have struck down Commission rulemakings for failing to adhere to the statutory standard for considering whether the action will promote efficiency, competition, and capital formation and for failing to respond to substantial problems raised by commenters. *Business Roundtable v. Commission*, 647 F. 3d 1144 (D.C. Cir. 2011); *Am. Equity Inv. Life Ins. Co. v. Commission*, 613 F.3d 166 (D.C. Cir. 2010); *Chamber of Commerce v. Commission*, 412 F.3d 133 (D.C. Cir. 2005). In a recent rulemaking challenge, the D.C. Circuit Court of Appeals was willing to give the Commission some latitude in departing from a "rigorous, quantitative economic analysis" of the benefits of the rule where (1) Congress mandated a rule and made a determination as to the rule's social benefits, and (2) the benefits "concern[ed] a subject about which the Commission ha[d] no particular expertise." *Nat'l Asso. of Manufacturers v. Commission*, No. 13-5252 at *8 (D.C. Cir. Apr. 14, 2014). In the MMF rulemaking, however, the Commission has determined to exercise its discretion to adopt a rule for the protection of investors and in the public interest, and is compelled under the statute to consider whether the rule will promote efficiency, competition, and capital formation. The MMF rulemaking is clearly within the Commission's expertise and the Commission has a robust rulemaking file and available data which, while inexact, points to the effects – benefits and costs – of the proposed rules and allows the Commission to compare those benefits and costs among alternatives.

[46] Release at 36917.

rules on investor protection, efficiency, competition, and capital formation. Neither the Commission's Release nor the comment file provide adequate support for a finding that a floating NAV would protect investors or promote efficiency, competition, or capital formation. The record *does* support a finding that Alternative Two maintains MMFs as an efficient, pro-competitive investment that positively impacts short-term funding markets and that it avoids the negative impacts of a floating NAV. In this regard, Alternative Two, as compared to a floating NAV –

- Preserves MMFs as a cash management option for investors, rather than forcing investors to shift funds to less transparent and more risky assets such as bank deposits because of statutory or other legal barriers to investing in floating NAV assets;

- Provides MMF boards with an additional tool to protect investors by ensuring equitable outcomes in a crisis;

- Promotes efficiency by preserving the existing tax, recordkeeping, and operational benefits of stable value MMFs (including same-day settlement periods) rather than adding additional burdens;

- Avoids increasing systemic risk by avoiding the possibility that MMF assets will shift to too-big-to-fail banks or that pricing vendor outages will lead to cascading payment system failures;

- Promotes competition by preserving a higher yield, more transparent, less risky alternative to bank deposits (particularly for funds in excess of FDIC insurance limits) or other less regulated products;

- Avoids the possibility that the bulk of prime and municipal MMF assets would shift into government securities MMFs and potentially overwhelm the available supply of short-term government securities;[47] and

[47] *Cf.* Stefania D'Amico, et al., *The Scarcity Value of Treasury Collateral: Repo Market Effects of Security-Specific Supply and Demand Factors*, Federal Reserve Bank of Chicago Working Paper No. 2013-22 (Nov. 2013) (analyzing forward agreements in the repo market and finding that reductions in the supply of the underlying collateral (*i.e.*, Treasury securities) leads to a persistent, "economically and statistically significant" scarcity premium, particularly for short-term securities).

- Promotes capital formation by preserving the role of MMFs as suppliers of lower-cost short-term funding to issuers, including corporations and state and local governments, rather than reducing the role MMFs play in short-term funding markets as investors shift assets away from prime MMFs.

Conclusion

The record justifies adoption of Alternative Two, which would be more effective if modified along the lines that Federated and other commenters have proposed. We urge the Commission to adopt Alternative Two with the suggested modifications, along with appropriate enhanced disclosures, to achieve its stated reform goals. The record is utterly bereft of data, analyses, or fact-based evidence supporting adoption of Alterative One. Therefore, we urge the Commission to reject Alternative One given the Commission's statutory obligations and binding Guidance. We hope this letter proves helpful to the Commission as it considers final rules for MMF reform. We appreciate the opportunity to provide comments on the Release.

Sincerely,

David F. Freeman, Jr.