MEMORANDUM

To: Meeting with representative of Federated Investors, Inc. relating to rule amendments proposed in Securities Exchange Act Release No. 55431 (File No. S7-08-07), titled "Amendments to Financial Responsibility Rules for Broker-Dealers"

From: Office of the Chairman

Date: August 14, 2008

Subject: Meeting with representative of Federated

On August 8, 2008, Chairman Christopher Cox and James Eastman, Counsel to the Chairman, met with Michael Oxley of Baker & Hostetler. Baker & Hostetler represents Federated Investors, Inc. and Mr. Oxley discussed issues raised by Federated in submissions it has made with the Commission that are contained in this rulemaking file. Mr. Oxley also provided the Office of the Chairman a written summary of the issues raised by Federated. A copy of this summary is attached to this memorandum.

MEMORANDUM

To: The Honorable Christopher Cox, Chairman, U.S. Securities and Exchange Commission (the "Commission" or the "SEC").

From: The Honorable Michael G. Oxley, Baker Hostetler.

Re: Federated Investors Inc. ("Federated") request for amendments to Rule 15c3-3[1] and Rule 15c3-1[2] (collectively, the "Rules").

Date: July 28, 2008

I appreciate the opportunity to have spoken with you on July 16, 2008, regarding the status of Federated's request for changes to the Rules.[3] I thought it would be useful to discuss these issues in greater detail and to address some concerns that may exist.

Concern: *The proposed changes benefit Federated exclusively and are not supported by the fund industry or the broker-dealer community. By approving these changes, the Commission only would be benefiting one firm. The proposal offers no benefits to the public and only would increase risks to broker-dealers.*

Facts:

1. Federated seeks changes that would be available to any money market fund that meets the Commission's standards.[4] These changes would not solely benefit Federated. Federated has proposed amendments to the Rules that would be an open and transparent standard that other funds could meet. Federated fully expects that other fund complexes will compete with Federated for broker-dealers' assets.[5]

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1 17 CFR §240.15c3-3 under the Securities Exchange Act of 1934 (the "Exchange Act"). Federated seeks amendments that would permit broker-dealers to: (i) deposit or pledge certain "qualified money market funds" to their special reserve bank accounts; and (ii) use money market funds that satisfy Rule 2a-7 under the Investment Company Act of 1940 (the "1940 Act") (*i.e.*, "Rule 2a-7 Funds") as collateral for fully-paid or excess margin securities.

2 17 CFR §240.15c3-1. Federated seek amendments that would reduce the haircut from 2% for all money market funds to: (i) 1% for Rule 2a-7 Funds; and (ii) 0.5% for qualified money market funds.

3 Our request comes in the context of an SEC request for comment on a number of changes to the Rules. Exchange Act Release 55431 (March 9, 2007); 72 FR 12862 (March 19, 2007) (the "Release"). Federated previously had filed an amended petition for rulemaking, discussed in the Release. Federated's views are well documented in the public file. *See e.g.*, File From: Hester Peirce Re: Proposed Rule: Amendments to Financial Responsibility Rules for Broker-Dealers, File No. S7-08-07; June 6, 2008 attaching letter from Stuart J. Kaswell, Bryan Cave LLP to Hester M. Peirce, Counsel, Office of Commissioner Paul S. Atkins, May 30, 2008, and attachments, available at http://www.sec.gov/comments/s7-08-07/s70807-68.pdf.

4 Attached are Federated's proposals for a "qualified money market fund" that would constitute a qualified security under Rule 15c3-3(a)(6) and therefore would be qualified for the special reserve bank account. We also include our other proposals for change.

5 For example, UBS Global Asset Management filed a letter on June 18, 2007 in support of these changes and urging specific changes to the proposal. In response to Federated's original rule petition of April 3, 2003, Dreyfus Corporation filed a letter in support on January 7, 2004.

2. The financial services industry, including the broker-dealer community, broadly supports changes to the Rules. Of the sixty-five comment letters or memoranda of meetings in the public file, only one opposed amending the Rules as we suggest.[6] Numerous other commentators support amending the Rules and urge the Commission to broaden its proposal along the lines that we now suggest. The commentators differed only on *how* to make the changes we seek.[7]

3. Federated has repeatedly demonstrated to the Staff that the broker-dealer community eagerly seeks these changes and that Federated is simply responding to the needs of its customers. For example, on May 12, 2008, we arranged a conference call with James Eastman of your Staff to respond to his questions about broker-dealer interest in the proposal. Representatives of Lehman Brothers and Harris Trust participated.[8] Federated remains confident of broker-dealers' support because it receives constant inquiries from broker-dealers about their desire to use money market funds for the purposes we seek. If Federated did not believe that the market for this product existed, we would have abandoned this effort years ago.

4. The proposals offer operational benefits, do not increase risk, and, in fact, may reduce it.

   Special Reserve Bank Account -- Currently, a broker-dealer may deposit only cash or a *qualified security*[9] into the special reserve account. Accordingly, a broker-dealer must either:

   A. Assemble and actively manage a portfolio of U.S. Treasury securities, to ensure that the broker-dealer has sufficient funds in the Special Reserve Bank account. The Release notes that a "broker-dealer might choose to deposit qualifying money market fund shares into the customer reserve account based on operational considerations such as avoiding the need to actively manage a portfolio of U.S. Treasury securities."[10] Even major houses with government trading desks have indicated that they would prefer to avoid the operational risks associated with this activity; OR

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6 The Securities Investor Protection Corporation opposed expanding the definition of "qualified security" under Rule 15c3-3(a)(6) to include Treasury-only money market funds, out of concern that broker-dealers could fabricate the existence of money market fund deposits. Briefly, it is our view that it is no more or less difficult to fabricate the existence of a money market fund than of a bank deposit.

7 For example, SIFMA had specific recommendations on which money market funds should constitute "qualified securities" and on the amount of the haircut. Marshall J. Levinson, Senior Managing Director, Bear, Stearns & Co. Inc., Chair, SIFMA Capital Committee, June 15, 2007, available at http://www.sec.gov/comments/s7-08-07/s70807-32.pdf.

8 Memorandum, Meeting with representatives of Federated Investors, Inc. relating to rule amendments proposed in Securities Exchange Act Release No. 55431 (File No. S7-08-07), titled "Amendments to Financial Responsibility Rules for Broker- Dealers" From: Office of the Chairman May 12, 2008, available at http://www.sec.gov/comments/s7-08-07/s70807-65.pdf. We have arranged similar meetings and calls between the Staff and representatives of other firms, such as Deutsche Bank.

9 Rule 15c3-3(a)(6) currently defines a "qualified security" as "a security issued by the United States or a security in respect of which the principal and interest are guaranteed by the United States."

10 Release at 12865.

B. Deposit cash into the account, putting the funds at risk of the balance sheet of the bank. Banks are not required to separate the broker-dealer's cash and hold it separately from the bank's other assets.[11] By comparison, Rule 17f-1 under the 1940 Act requires registered investment companies to hold portfolio assets with a custodian.

Collateral – Currently, broker-dealers may pledge an unsecured bank letter of credit as collateral when borrowing customers' fully-paid or excess margin securities. Clearly, the Commission would strengthen investor protection by allowing broker-dealers to pledge money market funds, which are less risky than such unsecured bank letters of credit, particularly at a time when several banks are reportedly at risk of failure.[12]

Haircut – The Commission itself has proposed a reduction in the haircut from 2% to 1% for Rule 2a-7 Funds. We agree with the proposed reduction to 1% for Rule 2a-7 Funds but believe the Commission should reduce the haircut to 0.5% for qualified money market funds. Such a change would be in proportion to other haircuts for investments with similar risk profiles and would not compromise investor protection.[13]

In summary, these changes would improve efficiency, not increase risk, may even lower it, and would modernize SEC rules that currently favor banks. Notably, both the Commodity Futures Trading Commission[14] and the UK's Financial Services Authority[15] allow use of money market funds in analogous situations.

Concern: *Federated's latest proposal would allow broker-dealers to use money market funds with portfolio securities issued by Fannie Mae and Freddie Mac. It is simply too risky to allow broker-dealers to protect customers' funds by relying on such securities.*

Facts: The Commission proposes allowing broker-dealers to use money market funds that, among other things, invest only in assets consisting solely of cash and securities issued by the United States or guaranteed by the United States with respect to principal and interest.[16] We suggest changing this proposal to include securities issued or guaranteed by the United States government or its agencies or instrumentalities (including repurchase and reverse repurchase transactions). That difference would include certain debt securities issued by the Fannie Mae and Freddie Mac. We have suggested this change because these bonds pay a slightly higher yield than U.S. Treasuries.[17] Without this additional yield, broker-dealers are not interested in

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11 *See* Attachment at Item 1 for proposed text.

12 *See* Attachment at Item 2 for proposed order.

13 *See* Attachment at Item 3 for proposed text. Haircuts of 1%/0.5% would be very conservative, compared with haircuts for other asset classes under the current rule. *See* letter to the Honorable Christopher Cox, Chairman, SEC, *et al.*, from Stuart J. Kaswell, Dechert LLP, October 9, 2007, at 9, available at http://www.sec.gov/comments/s7-08-07/s70807-60.pdf

14 Rule 1.25. (17 CFR §1.25).

15 FSA, Client Assets Sourcebook ("CASS"), ch. 7.

16 Release at 12894.

17 We are not suggesting that the money market funds could invest in the common stock of Fannie Mae or Freddie Mac.

buying the qualified money market funds to comply with Rule 15c3-3.[18] In other words, without this change, this aspect of the Release becomes a "dead letter."

The markets have always assumed that Fannie Mae and Freddie Mac bonds would have an implicit U.S. Government guarantee, but no one knew if that assumption was true. Based on recent events, we now know that the U.S. Government will back Fannie and Freddie bonds. President Bush stated in a press conference on July 15, 2008:

> In this case, there is a feeling that the government will stand behind mortgages through these two entities. And therefore, we felt a special need to step up and say that we are going to provide, if needed, temporary assistance through either debt or capital. *** [In response to a question:] You know, there is an implicit guarantee.[19]

On July 13, 2008, the Board of Governors of the Federal Reserve System announced:

> The Board of Governors of the Federal Reserve System announced Sunday that it has granted the Federal Reserve Bank of New York the authority to lend to Fannie Mae and Freddie Mac should such lending prove necessary. Any lending would be at the primary credit rate and collateralized by U.S. government and federal agency securities. This authorization is intended to supplement the Treasury's existing lending authority and to help ensure the ability of Fannie Mae and Freddie Mac to promote the availability of home mortgage credit during a period of stress in financial markets.[20]

Freddie Mac was able to sell $3 billion in securities after the Fed and Treasury's announcements.[21]

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18 Reducing the haircut under Rule 15c3-1 is also important to making qualified money market funds attractive to broker-dealers.

19 Press Conference of George W. Bush, July 15, 2008, http://www.whitehouse.gov/news/releases/2008/07/20080715-1.html

20 http://www.federalreserve.gov/newsevents/press/other/20080713a.htm. *See also* testimony of the Honorable Henry Paulson, Secretary, Department of the Treasury, Testimony on GSE Initiatives before the Senate Banking Committee, HP-1080, July 15, 2008, (available at http://www.treas.gov/press/releases/hp1080.htm) regarding proposed legislation.

21 On July 15, 2008, THE WALL STREET JOURNAL reported:

> Freddie Mac passed a crucial test of investor confidence Monday when there was strong demand for short-term debt it was selling, but that was no solace to stock investors who continue to watch the stocks erode. A closely watched auction of $3 billion in Freddie's short-term debt drew more bids than usual. The company was able to sell its three- and six-month notes at lower-than-expected yields, which in turn helped keep its borrowing costs low.

"Freddie Mac Auction Eases Concerns," July 15, 2008; Page A15, available at http://online.wsj.com/article/SB121603898437750725.html?mod=googlenews_wsj On July 18, 2008, Freddie Mac became a voluntarily reporting company with the Commission. Fannie Mae achieved similar status in 2004. *See* SEC, Freddie Mac Now SEC Reporting Company, Press Release 2008-145, available at http://www.sec.gov/news/press/2008/2008-145.htm, and authorities cited therein.

To put this situation in context, James B. Lockhart III, Director, OFHEO recently noted that:

> The combined credit market footprint of Fannie Mae and Freddie Mac rivals the liabilities of the Fed and the U.S. government. At the end of March [2008], those two housing GSEs had credit outstanding of $5.3 trillion, including debt of $1.6 trillion and guaranteed mortgage-backed securities (MBS) of $3.7 trillion ... That was equal to the publicly held debt of the U.S. government, of which over $600 billion was not so publicly held by the Fed.[22]

It is inconceivable that the U.S. Government would let these two Government Sponsored Entities ("GSEs") fail, with enormous ripple effects on both the housing markets and on the institutions holding their debt. What ever question lingered about whether the Federal Government would back the GSEs was answered in recent days by President Bush, Chairman Bernanke, and Secretary Paulson. Moreover Congress recently passed legislation that President Bush has indicated he will sign that would statutorily authorize U.S. Government support of the GSE's.[23] Further, the Congressional Budget Office estimates that in all probability, such authority will not need to be used.[24] Accordingly, to suggest that Freddie or Fannie bonds are too risky an investment for a qualified money market fund is to ignore the facts.

We also believe it is useful to compare the proposed qualified money market funds for the Special Reserve Bank Account with cash deposits, usually held in a "trust ledger account" at commercial banks. In particular, we understand that some U.S. banks that offer this product for broker-dealers' Special Reserve Bank Accounts are at the same time looking for major capital infusions to stabilize their balance sheets. For example, one bank that is offering the trust ledger product announced plans to issue convertible preferred shares to raise $1 billion in Tier 1 capital, reduced its dividend, and is selling off non-core businesses. It is inconceivable that the Commission would favor deposits in such shaky banks over investments in qualified money market funds, with all of the protections of the 1940 Act for registered investment companies, the strict requirements of Rule 2a-7 under the 1940 Act[25], and the stability of portfolio assets

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22 Remarks of James B. Lockhart III Director, OFHEO 44th Annual Conference on Bank Structure and Competition, Chicago, IL May 16, 2008, available at http://www.ofheo.gov/newsroom.aspx?ID=433&q1=0&q2=0

23 H.R. 3221, Section 1117. Temporary Authority for Purchase of Obligations of Regulated Entities by Secretary of Treasury.

24 *See* letter from Peter Orszag, Director, Congressional Budget Office. to the Honorable John M. Spratt, Jr., Chairman, Committee on the Budget, U.S. House of Representatives, July 22, 2008.

25 The protections Rule 2a-7 under the 1940 Act include the following protections:

- **portfolio diversification** – taxable money market funds must limit their investments in the securities of any one issuer (other than Government securities) to five percent of fund assets. Rule 2a-7(c)(4)(i).
- **portfolio maturity** — a money market fund must not (with certain limitations) acquire any instrument that has a remaining maturity of greater than 397 days or have a dollar-weighted average maturity that exceeds ninety days. Rule 2a-7(c)(2).
- **portfolio quality** – a taxable money market fund shall not have invested more than five percent of its total assets in securities that are second tier securities. Rule 2a-7(c)(3)(ii)(A); and

limited to investments in securities issued or guaranteed by the United States government or its agencies or instrumentalities (including repurchase and reverse repurchase transactions). As noted, purchasing and selling Treasury securities involves operational risk for the broker-dealer, and involves constant time and expense.

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This memorandum should address any concerns about the nature of our proposal. We believe that our proposal will not harm investor protection and indeed, offer benefits over the current rules. We hope the Commission will agree and act expeditiously on our recommendations.

Please contact me if you have further questions.

Attachment

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- **portfolio liquidity** – a money market fund may not invest more than ten percent of its assets in illiquid securities Rule 2a-7.

Attachment

SEC proposal from the Release marked to show Federated's suggested ~~deletions~~ and *additions*:

1. Definition of "qualified money market fund":

Section 240.15c3-3 is amended by revising paragraph (a) to provide:

(6) The term qualified security shall mean:

(i) A security issued by the United States or guaranteed by the United States with respect to principal or interest; and

(ii) A qualified money market fund which shall be defined as a redeemable security of an unaffiliated investment company registered under the Investment Company Act of 1940 and described in § 270.2a-7 of this chapter that:

(A) ~~Has assets consisting solely of cash and securities issued by the United States or guaranteed by the United States with respect to principal and interest;~~ *Limits its investments to securities issued or guaranteed by the United States government or its agencies or instrumentalities (including repurchase and reverse repurchase transactions)*;

(B) Agrees to redeem fund shares in cash no later than the business day following a redemption request by a shareholder; and

(C) *After the completion of the purchase*, ~~H~~has net assets (assets net of liabilities) equal to at least 10 times the value of the fund shares held by the broker-dealer in the customer reserve account required under paragraph (e) of this section.*

2. Definition of collateral for pledge to customers' for fully-paid or excess margin securities (not in Release but permitted by SEC order):

Order pursuant to Section 36 of the Exchange Act, designating an additional type of collateral as permissible under Rule 15c3-3(b)(3)(iii)(A) as necessary or appropriate in the public interest and consistent with the protection of investors after giving consideration to the collateral's liquidity, volatility, market depth and location, and the issuer's creditworthiness:

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* Federated suggests this amendment to subsection (C) only in the interest of clarifying what we understand to be the Commission's intention.

Redeemable securities issued by one or more open-end management companies registered under Section 8 of the Investment Company Act of 1940 and described in 17 CFR 270.2a-7.

3. Proposed Reduction in the haircut under the net capital rule:

Section 240.15c3-1 is amended by revising paragraph(c)(2)(vi):

(D)(1) In the case of redeemable securities of an investment company registered under the Investment Company Act of 1940,which assets consist of cash or money market instruments and which is described in §270.2a-7 of this Chapter, the deduction shall be 1% of the market value of the greater of the long or short position; *provided however that in the case of redeemable securities of a qualified money market fund as defined in §240.15c3-3(a)(6)(ii) of this Chapter, the deduction shall be 0.50% of the market value of the greater of the long or short position.*