

April 4, 2005

Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, DC 20549-0609

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Re: Petition for Rulemaking

Dear Mr. Katz:

On behalf of Federated Investors, Inc. ("Federated" or "Petitioner"),¹ Dechert LLP hereby petitions the Securities and Exchange Commission ("Commission" or the "SEC") to amend: (i) Rule 15c3-1 under the Securities Exchange Act of 1934, as amended ("1934 Act") to provide the same net capital treatment to broker-dealers' investments in shares of certain investment companies registered under the Investment Company Act of 1940, as amended ("1940 Act") as is currently provided to direct investments in securities issued or guaranteed as to principal or interest by the United States government or any agency thereof ("Government securities") with maturities of less than three months; and (ii) Rule 15c3-3 under the 1934 Act to: (a) provide the same collateral treatment to such investment company shares as is provided to cash, United States Treasury bills, United States Treasury notes, irrevocable letters of credit issued by banks and such other collateral as the Commission designates by order after giving consideration to the collateral's liquidity, volatility, market depth and location, and the issuer's creditworthiness (collectively, "Rule 15c3-3 collateral"); and (b) treat such investment company shares as "qualified securities" that may be deposited into a broker-dealer's Special Reserve Bank Account for the Exclusive Benefit of Customers ("Special Reserve Account").²

To qualify for equivalent treatment under Rule 15c3-1 and Rule 15c3-3, the shares would have to be issued by a registered investment company that: (i) meets the conditions of paragraphs (c)(2), (c)(3) and (c)(4) of Rule 2a-7 under the 1940 Act ("money market fund") and (ii) has received the highest money market fund rating

¹ Federated is one of the largest investment management organizations in the United States, with total assets under management of approximately \$179.3 billion as of December 31, 2004. Federated's money market assets in both funds and separate accounts totaled \$124.3 billion at December 31, 2004. Average money market assets were \$125.3 billion for the quarter ended December 31, 2004. Federated's money market funds are used for cash management and short-term investment by a wide array of institutions, including banks, corporate fiduciaries, broker-dealers, business organizations and public entities.

² This petition amends Federated's original petition, as filed on April 3, 2003.

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from a nationally recognized statistical rating organization ("NRSRO") (a "Designated Fund" or "AAA rated MMF"). Federated's Prime Obligation Fund and Prime Cash Obligations Fund have both received the highest rating from Standard & Poor's (AAAm) and thus would both qualify as Designated Funds under this standard.³

The text of the proposed amendments are set forth in Exhibit A to this petition.

Numerous financial regulators, self-regulatory organizations, and state legislatures have approved the use of money market funds similar to Designated Funds for use by institutional investors as a safe and efficient alternative to direct investments in Government securities.⁴ Petitioner submits that the Commission should amend Rules 15c3-1 and 15c3-3 to recognize that investments in Designated Funds serve as functional equivalents of investments in Government securities, Rule 15c3-3 collateral or qualified securities for purposes of those rules as well.

SUMMARY

Rule 15c3-1 seeks to ensure that broker-dealers maintain sufficient liquid capital to protect the assets of customers and to meet their responsibilities to other broker-dealers.⁵ When calculating the value of their assets for the purposes of establishing their net capital under Rule 15c3-1, broker-dealers must reduce the market value of the securities and commodities they own by certain percentages – so-called "haircuts".⁶ The applicable percentage haircut is designed to provide protection from the market risk, credit risk, and other risks inherent in particular positions. Discounting the value of a broker-dealer's proprietary positions provides a capital cushion in case the portfolio value of the broker-dealer's positions decline.⁷

Rule 15c3-3, the Commission's customer protection rule, governs a broker-dealer's acceptance, custody and use of a customer's securities.⁸ The Commission adopted

³ Quarterly "fact sheets" for the Federated Prime Obligations Fund and the Federated Prime Cash Obligations Fund for the fiscal quarter ended December 31, 2004 are included as Exhibit D for your reference.

⁴ Exhibit B lists those federal and state financial regulators and state legislatures that have recognized investments in shares of money market funds as safe alternatives to direct investments.

⁵ *Net Capital Rule*, Securities Exchange Act Rel. No. 39455 (Dec. 17, 1997), 62 FR 67996 (Dec. 30, 1997).

⁶ *Id.*

⁷ *Net Capital Rule*, Securities Exchange Act Rel. No. 39456 (Dec. 17, 1997), 62 FR 68011, 68012 (Dec. 30, 1997).

⁸ *Customer Protection--Reserves and Custody of Securities*, Securities Exchange Act Rel. No. 47480 (March 11, 2003), 68 FR 12779, 12780 (March 17, 2003) ("*Reserves and Custody Adopting Release*"); *Customer Protection--Reserves and Custody of Securities*, Securities Exchange Act Rel. No. 46019 (June 3, 2002), 67 FR 39642 (June 10, 2002) ("*Reserves and Custody Proposing Release*").

Rule 15c3-3 in 1972, in part, to ensure that a broker-dealer in possession of customers' funds either deployed those funds "in safe areas of the broker-dealer's business related to servicing its customers" or, if not deployed in such areas, deposited the funds in a reserve bank account to prevent commingling of customer and firm funds.⁹ Rule 15c3-3 seeks to inhibit a broker-dealer's use of customer assets in its business by prohibiting the use of those assets except for designated purposes.¹⁰ The Rule also aims to protect customers involved in a broker-dealer liquidation.¹¹ If a broker-dealer holding customer property fails, Rule 15c3-3 seeks to ensure that the firm has sufficient reserves and possesses sufficient securities so that customers promptly receive their property and there is no need to use the Securities Investor Protection Corporation fund.¹²

Rule 15c3-3 currently permits broker-dealers to borrow customers' fully paid or excess margin securities only if, among other things, the loan is fully collateralized with Rule 15c3-3 collateral.¹³ The Commission recently has adopted amendments to Rule 15c3-3 that will allow the Commission to designate by order new categories of broker-dealer assets as permissible Rule 15c3-3 collateral.¹⁴ For these purposes, the Commission will consider the quality and liquidity of a particular instrument, including the creditworthiness of the issuer of the instrument, the depth of the instrument's market, the locations where the instrument is traded, and the historical volatility of the instrument's price, before designating it as permissible Rule 15c3-3 collateral.¹⁵

The Commission also adopted a companion rule that delegates to the Director of the Division of Market Regulation the authority to issue exemptive orders permitting broker-dealers to use additional types of collateral not currently specified in Rule 15c3-3, provided the collateral has characteristics similar to those of collateral previously permitted by the Commission.¹⁶ The Commission stated that it intends to issue an order designating as Rule 15c3-3 collateral:

⁹ Rule 15c3-3 Reserve Requirements for Margin Related to Security Futures Products, Securities Exchange Act Rel. No. 46492 (Sept. 12, 2002), 67 FR 59747, 59748 (Sept. 23, 2002) ("Security Futures Reserve Release").

¹⁰ *Id.*

¹¹ *Id.*

¹² *Id.* See also SEC, Study of Unsafe and Unsound Practices of Brokers and Dealers, H. Doc. 92-231 (92d. Cong., 1st Sess.) (Dec. 1971), at 30 *et seq.*

¹³ *Reserves and Custody Proposing Release*, *supra* note 8, 67 FR at 39643.

¹⁴ *Reserves and Custody Adopting Release*, *supra* note 8, 68 FR at 12781.

¹⁵ *Id.*

¹⁶ *Id.*

- (i) "government securities" as defined in Sections 3(a)(42)(A) and (B) of the 1934 Act;
- (ii) certain "government securities" meeting the definition in Section 3(a)(42)(C) of the 1934 Act;
- (iii) securities issued or guaranteed by certain Multilateral Development banks;
- (iv) "mortgage related securities" as defined in Section 3(a)(41) of the 1934 Act;
- (v) certain negotiable certificates of deposit and bankers acceptances;
- (vi) foreign sovereign debt securities;
- (vii) foreign currency; and
- (viii) certain corporate debt securities.¹⁷

The Commission did not indicate, however, that it had considered or would be willing to issue an order designating money market fund shares as Rule 15c3-3 collateral.

In addition to imposing collateral requirements upon broker-dealers' borrowings of customers' fully paid or excess margin securities, Rule 15c3-3 requires a broker-dealer to calculate what amount, if any, it must deposit on behalf of customers in the Special Reserve Account, according to the formula set forth in Rule 15c3-3a ("Reserve Formula").¹⁸ Generally, under the Reserve Formula, a broker-dealer must calculate any amounts it owes to its customers and the amount of funds generated through the use of customer securities, called credits, and compare this amount to any amounts its customers owe it, called debits.¹⁹ If customer credits exceed customer debits, the broker-dealer must deposit the net amount of customer credits in the Special Reserve Account.²⁰ Under Rule 15c3-3(e)(1), only cash or "qualified securities" may be deposited into a Special Reserve Account. Rule 15c3-3(a)(6) 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."

¹⁷ *Id.*

¹⁸ *Security Futures Reserve Release*, *supra* note 8, 67 FR at 59748.

¹⁹ *Id.*

²⁰ *Id.*

Petitioner submits that shares of Designated Funds do not present any increased market risk, credit risk or other risks relative to direct holdings of Government securities or other approved Rule 15c3-3 collateral. Similarly, the quality and liquidity of shares of Designated Funds are equivalent to the quality and liquidity of current Rule 15c3-3 collateral, and may exceed the quality and liquidity of certain of the types of collateral that the Commission has stated that it will designate by order as permissible Rule 15c3-3 collateral. Moreover, the deposit of shares of Designated Funds into Special Reserve Accounts does not present any increased risk that if a broker-dealer holding customer property fails, the broker-dealer will not have sufficient reserves to ensure that customers promptly receive their property.

It should be noted that Designated Funds attempt to maintain a stable net asset value per share of \$1.00, and permit shareholders to purchase and sell in precise dollar amounts, whereas transactions in Government securities take place only in large denominations and may cause a broker-dealer to incur a loss when selling a Government security. Consequently, the use of Designated Funds will facilitate a broker-dealer's ability to meet its cash management needs by providing high daily liquidity at par, which will assist a broker-dealer in managing its changing liquidity requirements over time. We understand that the need for broker-dealers to manage their cash efficiently and in a highly cost-effective manner has increased markedly over the past few years, because the condition of the securities markets during this time period has prompted investors to hold more cash in their accounts. Consequently, we expect that if the Commission adopted the amendments to Rule 15c3-1 and Rule 15c3-3 proposed in this petition, broker-dealers would use shares of Designated Funds in the manner permitted by the amendments. We believe that broker-dealers and the securities markets would benefit in many respects from the use of Designated Fund shares in the manners proposed in this petition.

For example, if Designated Fund shares were acceptable Rule 15c3-3 collateral, it could be expected that liquidity would be added to the securities lending markets and borrowing costs for broker-dealers would be lowered.²¹ The proposed amendments to Rule 15c3-1 and Rule 15c3-3 would conform the treatment of money market fund shares under these rules to their treatment by other financial regulators, self-regulatory organizations and state legislatures. Furthermore, the use of Designated Fund shares, which may be traded in precise increments, will enable broker-dealers to manage their cash requirements more effectively than the use of Treasury securities, which must be traded in increments of \$1,000.

²¹ See *Reserves and Custody Adopting Release*, *supra* note 8, 68 FR at 12781.

PROPOSED RULE AMENDMENTS

Attached to this petition as Exhibit A is the text of proposed amendments to Rule 15c3-1 and Rule 15c3-3. The proposed amendments would permit shares of Designated Funds to be treated as the functional equivalent of Government securities, Rule 15c3-3 collateral and qualified securities for purposes of those rules. The amendments thus would eliminate undue restrictions under the Commission's current regulations, which provide disparate treatment for instruments with the same risk/reward characteristics. The amendments are intended to facilitate the ability of broker-dealers to comply with the Commission's financial responsibility and customer protection rules through investments in Designated Funds.

DISCUSSION

Rule 15c3-1 and Risks of Broker-Dealers

Rule 15c3-1 generally requires every registered broker-dealer to maintain certain specified minimum levels of liquid assets, or net capital, to enable those firms that fall below the minimum net capital requirements to liquidate in an orderly fashion without the need for a formal legal proceeding.²² The Rule is designed to protect the customers of a broker-dealer from losses that can be incurred upon a broker-dealer's failure.²³ The Rule prescribes different required minimum levels of capital based upon the nature of the broker-dealer's business and whether the firm handles customer funds or securities.²⁴

When calculating its net capital, a broker-dealer must reduce its capital by certain percentage amounts, or haircuts, based on the market value of the securities it owns.²⁵ The haircuts were designed to cover:

- **market risk** – the risk that prices or rates will adversely change due to economic forces, including adverse effects of movements in equity and interest rate markets, currency exchange rates, and commodity prices;
- **credit risk** – risk of loss resulting from counterparty default on loans, swaps, options, and other similar financial instruments during settlement;
- **liquidity risk** – the risk that a firm will not be able to unwind or hedge a position; and
- **operational risk** – the risk of loss due to the breakdown of controls within the firm including, but not limited to, unidentified limit excesses, unauthorized trading, fraud in trading or in back office functions,

²² *OTC Derivatives Dealers*, Securities Exchange Act Rel. No. 39454 (Dec. 17, 1997), 62 FR 67939, 67946 (Dec. 30, 1997).

²³ *Id.*

²⁴ *Id.*

²⁵ *Id.*

inexperienced personnel, and unstable and easily accessed computer systems.²⁶

Rule 15c3-3 and Risks of Broker-Dealers

The collateral requirements of Rule 15c3-3 are intended to prevent customer losses due to, among other things, the credit risks and liquidity risks associated with particular types of collateral.²⁷ The asset requirements applicable to Special Reserve Accounts are intended to prevent customer losses due to the operational risks of a broker-dealer.²⁸

Petitioner submits that the use of shares of Designated Funds in the manner contemplated in this petition would not give rise to any increased market risk, liquidity risk, credit risk or operational risk as compared to the use of Government securities, Rule 15c3-3 collateral, or qualified securities.

Money Market Funds – Background

Money market funds are open-end management investment companies registered under the 1940 Act that have as their investment objective generation of income and preservation of capital and liquidity through investment in short-term, high quality securities.²⁹ Money market funds were first introduced in 1972.³⁰ Total money market fund assets stood at \$ 1.906 trillion for the week ended Wednesday, March 24, 2005.³¹

Money market funds generally seek to maintain a stable share price, typically \$1.00 per share, in reliance upon Rule 2a-7 under the 1940 Act.³² This stable share price of \$1.00 has encouraged investors to view investments in money market funds as an alternative to bank deposits or checking accounts, even though money market funds lack federal deposit insurance, and there is no guarantee that money market funds

²⁶ *OTC Derivatives Dealers*, Securities Exchange Act Rel. No. 40594 (Oct. 23, 1998), 63 FR 59361, 59383, 59388 nn. 262-264 (Nov. 3, 1998); see *Notice of Filing and Immediate Effectiveness of a Proposed Rule Change Relating to the Placement of Highly Leveraged Members on Surveillance Status*, Securities Exchange Act Rel. No. 44995 (Oct. 26, 2001), 66 FR 55724 (Nov. 2, 2001) (publishing notice of filing and immediate effectiveness of SR-GSCC-2001-06).

²⁷ See *Reserves and Custody Proposing Release*, *supra* note 8, 67 FR at 39643.

²⁸ See *Security Futures Reserve Release*, *supra* note 9, 67 FR at 59748.

²⁹ *Revisions to Rules Regulating Money Market Funds*, Investment Company Act Rel. No. 21837 (Mar. 21, 1996), 61 FR 13955, 13957 (Mar. 28, 1996) ("*Money Market Rule Revisions*").

³⁰ Source: Investment Company Institute Mutual Fund Fact Book at inside front cover (42nd ed. 2002).

³¹ Source: Investment Company Institute,
http://www.ici.org/home/mm_03_24_05.html#TopOfPage.

³² *Money Market Rule Revisions*, *supra* note 27, 61 FR at 13957.

will maintain a stable share price.³³ Indeed, the Commission has observed that “investors generally treat money market funds as cash investments.”³⁴

Money market funds have been widely accepted by both retail and institutional investors. Institutional investors have been attracted to money market funds for various reasons. The Investment Company Institute has noted that “[t]he growth in business holdings of money funds is partly due to corporations’ preference to outsource cash management to mutual funds rather than holding liquid securities directly.”³⁵ Corporations that purchase money market shares are able to obtain daily liquidity at par, together with true daily choice, flexibility and economies of scale that are unavailable through internal management of their liquid assets.³⁶

Money Market Funds and their Regulation

To maintain a stable share price, the vast majority of money market funds use the amortized cost method of valuation or the penny-rounding method of pricing permitted by Rule 2a-7 under the 1940 Act. The 1940 Act and applicable rules generally require investment companies to calculate current net asset value per share by valuing portfolio instruments at market value or, if market quotations are not readily available, at fair value as determined in good faith by, or under the direction of, the board of directors. Rule 2a-7 exempts money market funds from these provisions, but contains conditions designed to minimize the deviation between a fund’s stabilized share price and the market value of its portfolio. In particular, Rule 2a-7’s conditions relating to portfolio diversification (paragraph (c)(4)), quality (paragraph (c)(3)), and maturity (paragraph (c)(2)) (collectively, the “risk-limiting conditions”) are intended to reduce the likelihood of significant deviations between a fund’s share price and its market based per share net asset value by requiring funds to invest in eligible quality instruments that are not significantly affected by changes in interest rates.³⁷

Portfolio Diversification

Rule 2a-7 subjects a money market fund to diversification requirements designed to limit the fund’s exposure to the credit risk of any single issuer. The applicability of the diversification requirements will depend on whether the fund is taxable, such as

³³ *Id.*

³⁴ *Shareholder Reports and Quarterly Portfolio Disclosure of Registered Management Investment Companies*, Investment Company Act Rel. No. 25870 (Dec. 18, 2002), 68 FR 160, 165 (Jan. 2, 2003).

³⁵ Investment Company Institute Mutual Fund Fact Book at 30 (42nd ed. 2002).

³⁶ *See id.*

³⁷ *Proposed Revisions to Rules Regulating Money Market Funds*, Investment Company Act Rel. No. 17539 (July 17, 1990), 55 FR 30239 (July 25, 1990). *See generally* Jack W. Murphy & Douglas P. Dick, *Money Market Funds*, in *FINANCIAL PRODUCT FUNDAMENTALS: A GUIDE FOR LAWYERS*, Ch. 9 (Clifford E. Kirsch ed., 2001).

a Designated Fund, or tax-exempt. The issuer diversification requirements do not apply with respect to a money market fund's holdings of Government securities, because the Commission does not consider holdings of Government securities to present significant credit risk.³⁸ Taxable funds must limit their investments in the securities of any one issuer other than Government securities to five percent of fund assets.

Portfolio Quality

Money market funds may purchase only securities that are denominated in United States dollars,³⁹ pose minimal credit risk to the fund, and are "Eligible Securities" as defined in Rule 2a-7(c)(3)(i). "Eligible Securities" are defined generally as: (i) securities that are rated in one of the highest two short-term rating categories by the "Requisite NRSROs"⁴⁰; or (ii) comparable unrated securities. Taxable funds must limit aggregate fund investments in so-called second tier securities⁴¹ to no more than five percent of fund assets, with investment in the second tier securities of any one issuer being limited to the greater of one percent of fund assets or one million dollars.

Rule 2a-7(c)(3) further requires money market funds to limit portfolio investments to Eligible Securities determined to present minimal credit risks. This determination must be based on factors affecting the credit quality of the issuer in addition to any ratings assigned to the securities by an NRSRO. Accordingly, it is not sufficient for the board of directors of a money market fund simply to rely on the ratings assigned

³⁸ Rule 2a-7(c)(4)(i). The Rule's treatment of Government securities is derived from Section 5(b)(1) of the 1940 Act, which excludes investments in Government securities from the limitations imposed upon diversified investment companies with respect to investments in a single issuer.

³⁹ The Commission staff has issued two no-action letters permitting funds to hold themselves out as money market funds if they invested solely in debt securities denominated in a specified foreign currency, provided that the funds otherwise complied with the terms of Rule 2a-7. *SsgA International Liquidity Fund* (pub. avail. Dec. 2, 1998); *Five Arrows Short-Term Investment Trust* (pub. avail. Sept. 26, 1997). These funds seek to maintain a constant net asset value in their designated currency and accept purchases and effect redemptions only in that currency.

⁴⁰ The term "Requisite NRSROs" is defined in Rule 5b-3(c)(6) under the 1940 Act as any two nationally recognized statistical rating organizations ("NRSROs"), or, if only one NRSRO has issued a rating at the time the fund acquires the security, that NRSRO. "NRSRO" is defined in Rule 5b-3(c)(5) as any nationally recognized statistical rating organization, as that term is used in paragraphs (c)(2)(v)(E), (F) and (H) of Rule 15c3-1 under the 1934 Act, that is not an "affiliated person," as defined in section 2(a)(3)(C) of the 1940 Act, of the issuer of, or any insurer or provider of credit support for, the security.

⁴¹ Rule 2a-7(a)(20) defines a "second tier security" as an Eligible Security that is not a "first tier security." Rule 2a-7(a)(11) generally defines a first tier security as a security that is rated by the Requisite NRSROs in the highest rating category for short-term debt obligations, and comparable unrated securities.

to securities by an NRSRO.⁴² Rather, the investment adviser must assemble and maintain a credit file for each issuer sufficient to support the determination that the security presents a minimal credit risk to the fund. Rule 2a-7 permits the responsibility for the minimal credit risk determination to be delegated by the fund's board of directors,⁴³ and as a matter of practice money market funds take advantage of this flexibility. Nonetheless, the fund's board of directors remains ultimately responsible for the minimal credit risk determination and has responsibility for overseeing the determination.

A money market fund's board of directors must reassess promptly whether a security presents minimal credit risks when the fund's investment adviser becomes aware that an unrated security or a second tier security has been given a rating by any NRSRO below the NRSRO's second highest rating category. A money market fund must dispose of a defaulted or distressed security (e.g., one that no longer presents minimal credit risks) "as soon as practicable," unless the fund's board of directors specifically finds that disposal would not be in the best interests of the fund.⁴⁴

Portfolio Maturity

A money market fund is required to maintain a dollar-weighted average portfolio maturity appropriate to the objective of maintaining a stable net asset value per share. In addition, Rule 2a-7 provides that a money market fund may not acquire⁴⁵ any instrument having a remaining maturity of greater than 397 calendar days, and may not maintain a dollar-weighted average portfolio maturity of more than 90 days. The Commission has stated that the purpose of Rule 2a-7's maturity provisions is to limit a money market fund's exposure to interest rate risk.⁴⁶

When Rule 2a-7 was first adopted, the Rule limited the maximum remaining maturity of any portfolio instrument to one year.⁴⁷ The Commission amended the Rule to permit any money market fund using the amortized cost method to value its portfolio instruments to invest in securities with a remaining maturity of no more than thirteen months (397 days).⁴⁸ The Commission made this change in order to

⁴² See *Money Market Rule Revisions*, *supra* note 27, 61 FR at 13964 n. 88.

⁴³ *Id.*, 61 FR at 13973.

⁴⁴ *Id.*, 61 FR at 13961 n. 44.

⁴⁵ Rule 2a-7(a)(1) defines "acquire" to mean any purchase or subsequent rollover, but does not include the failure to exercise a demand feature.

⁴⁶ *Money Market Rule Revisions*, *supra* note 27, 61 FR at 13971.

⁴⁷ *Revisions to Rules Regulating Money Market Funds*, Investment Company Act Rel. No. 18005 (Feb. 20, 1991), 56 FR 8113, 8120 (Feb. 27, 1991). Rule 2a-7 defined "one year" as 365 days, but provided that in the case of an instrument that was issued as a one year instrument, but had up to 375 days until maturity, one year meant 375 days. *Id.*, 56 FR at 8120 n. 53.

⁴⁸ *Id.*, 56 FR at 8120.

accommodate funds purchasing annual tender bonds, and funds purchasing securities on a when-issued or delayed delivery basis.⁴⁹ These securities often are not delivered for a period of up to one month after the purchaser has made a commitment to purchase them.⁵⁰ Because the purchaser must “book” the security on the day it agrees to purchase it, the maturity period begins on that day.⁵¹

The Rule provides that the maturity of a portfolio security generally will be equal to the period remaining (calculated from the trade date or such other date on which the fund’s interest in the security is subject to market action) until the date, in accordance with the terms of the security, the principal amount of the security must unconditionally be paid, or in the case of a security called for redemption, the date on which the redemption payment must be made (the “final maturity”).⁵² A money market fund, however, may measure the maturity of a “variable rate security” or a “floating rate security” (collectively, “adjustable rate securities”) by reference to a date that is earlier than the final maturity date.

Rule 2a-7 defines a “variable rate security” as an instrument, the terms of which provide for the adjustment of the interest rate on specified dates and that, upon adjustment, can reasonably be expected to have a market value that approximates par value. A “floating rate” security is defined as an instrument, the terms of which provide for the adjustment of its interest rate whenever a specified benchmark changes and that, at any time, can reasonably be expected to have a market value that approximates par value. Under Rule 2a-7, the maturity of an adjustable rate Government security is determined with reference to the interest readjustment date if, upon readjustment, the security can reasonably be expected to have a market value that approximates its par value.⁵³

Portfolio Liquidity

Money market funds are also subject to stringent portfolio liquidity standards. A money market fund is limited to investing no more than ten percent of its assets in illiquid securities.⁵⁴ The Commission considers a security to be illiquid if it cannot

⁴⁹ *Id.*

⁵⁰ *Id.*

⁵¹ *Id.* For instruments such as “when issued” or “delayed delivery” securities, if the commitment to purchase is based upon either a set price or yield, then the maturity will be calculated based upon the commitment date. 56 FR at 8120 n. 53. See Rule 2a-7(d).

⁵² A security that is subject to a “mandatory tender feature” – i.e., a feature providing that the principal amount of the security will be paid off on a specified date unless the holder elects to remain invested – can be treated as having its maturity measured by reference to the payment date of the tender feature. *Money Market Rule Revisions*, *supra* note 27, 61 FR at 13970 n. 151.

⁵³ *Money Market Rule Revisions*, *supra* note 27, 61 FR at 13971.

⁵⁴ Investment Company Act Rel. No. 13380 (July 11, 1983), 48 FR 32555 (July 18, 1983) (adopting Rule 2a-7), at nn. 37-38.

be disposed of within seven days in the ordinary course of business at approximately the price at which the fund has valued it.⁵⁵ The Commission, however, has reiterated its staff's observation that, because a broker-dealer is normally required to settle securities transactions not later than three business days after the trade date ("T+3"), many money market funds must meet redemption requests within three days because a broker or dealer will be involved in the redemption process.⁵⁶ The Commission cautioned money market funds to assess the mix of their portfolio holdings to determine whether, under normal circumstances, they will be able to facilitate compliance with T+3 by brokers or dealers.⁵⁷ The Commission advised money market funds to consider factors such as the percentage of the portfolio that would settle in three days or less, the level of cash reserves, and the availability of lines of credit or interfund lending facilities when conducting their assessment.⁵⁸ The Commission urged money market funds to monitor carefully their liquidity needs.⁵⁹

Safety Record of Money Market Funds Generally

General-purpose money market funds⁶⁰ have amassed an impressive record of safety over a period of 33 years. The vast majority of those funds have never invested in any money market instrument that did not pay off at maturity. There have been relatively isolated circumstances which a money market fund has experienced the potential for deviations between its stabilized share price and its market based per share net asset value by virtue of its investments in: (a) second-tier commercial paper; or (b) adjustable rate securities in which the interest rate readjustment formulas resulted in the market values of the securities not returning to par at the time of an interest rate readjustment. In all but one such instance, however, to maintain their funds' stable net asset values, the funds' investment advisers purchased the distressed or defaulted securities from their money market funds at their amortized cost value (plus accrued interest), or contributed capital to the funds, to preserve the fund's \$1.00 share price.⁶¹ Subsequent Commission amendments to

⁵⁵ *Money Market Rule Revisions*, *supra* note 27, 61 FR at 13966.

⁵⁶ *See id.*, citing Letter from Jack W. Murphy, Associate Director and Chief Counsel, Division of Investment Management, to Paul Schott Stevens, General Counsel, Investment Company Institute (May 26, 1995)

⁵⁷ *See id.*

⁵⁸ *See id.*

⁵⁹ *Id.*

⁶⁰ The term "general purpose money market funds" refers to money market funds that may invest in the full panoply of instruments permitted by Rule 2a-7.

⁶¹ *Id.*, 61 FR at 13972 n. 162. One institutional money market fund holding adjustable rates notes, a series of Community Bankers Mutual Fund, Inc., liquidated in September 1994 at 96 cents per share. Press reports generally treated this liquidation as the first instance in which a money market fund had "broken a dollar." *Id.*

In a subsequent enforcement action, the Commission found that the fund's two portfolio managers had not assessed adequately the risks of investing a large portion of the fund's

Rule 2a-7 have greatly limited the ability of a money market fund to invest in second-tier commercial paper, and have prohibited a money market fund from investing in an adjustable rate security if its interest rate readjustment formula does not ensure that the market value of the security will return to par once a readjustment occurs.

Petitioner believes that the record of money market funds amply demonstrates that Rule 2a-7 has operated and does operate successfully to minimize any credit, interest rate or liquidity risk created by an investment even in a general-purpose money market fund. As compared to these funds, however, concerns about credit, interest rate or liquidity risks are minimized still further in the context of Designated Funds because to qualify as a Designated Fund, the money market fund must meet the more stringent requirements necessary to receive the highest rating from an NRSRO. The conditions that a money market fund must satisfy to meet the definition of a Designated Fund should provide yet additional assurance that an investment in shares of a Designated Fund does not present any market, credit, liquidity, or operational risk not presented by a direct investment in Government securities, Rule 15c3-3 collateral, or qualified securities.

Additional Requirements for AAA-rated Money Market Funds

This fundamental point can be most readily understood through a quick review of the basic S&P criteria for a AAAM rating⁶² and a comparison of those criteria to the characteristics of investments that are currently permitted under Rules 15c3-1 and 15c3-3. While the other NRSROs follow similar approaches, this discussion will focus on S&P's ratings criteria.

S&P engages in an extremely sophisticated analysis of a money market fund before granting its AAAM rating. S&P examines credit risk, market price risk, pricing policies, operating scenarios, and controls for the money market fund. S&P will not designate a money market fund as AAAM rated unless the fund meets and maintains those very high standards.

portfolio in such derivatives, in an environment of rising short-term interest rates. *In the Matter of Craig S. Vanucci and Brian K. Andrew*, Securities Act Rel. No. 7625 (Jan. 11, 1999). In a related enforcement action, the Commission also found that the fund's board authorized the fund to sell its shares while omitting to disclose, or while making false and misleading disclosure of, material facts concerning the percentage of illiquid securities in the Fund's portfolio; and the value of the Fund's shares being sold. *In the Matter of John E. Backlund, John H. Hankins, Howard L. Peterson, and John G. Guffey*, Securities Act Rel. No. 7626 (Jan. 11, 1999).

⁶² These are discussed in great detail in S&P's 2003 publication *Money Market Funds Ratings Criteria*, a copy of which is included as Exhibit C for your reference ("*S&P MMF Ratings Criteria*"). Other NRSROs follow generally similar approaches to rating money market funds, but have not published as detailed a discussion of their criteria.

S&P's AAAM rating is defined to mean that:

Safety is excellent. Fund provides superior capacity to maintain principal value and limit exposure to loss.⁶³

The criteria that must be met to qualify for such a rating are as follows:

- (i) at least 50% of the money market fund's investments must have a short-term rating of A-1+ (which is the highest gradation of the highest S&P short-term rating);
- (ii) no more than 50% of the money market fund's investments may have a short-term rating of A-1;
- (iii) none of the fund's investments may have a short-term rating of A-2 (which is S&P's second highest short-term rating category);
- (iv) the money market fund's weighted average maturity must not exceed 60 days; and
- (v) the maximum final maturity for floating rate notes in which the money market fund invests must not exceed two years.⁶⁴

Significantly, for purposes of these ratings, S&P treats investments in short-term U.S. Treasury securities the same as investments in short-term A-1 rated investments. Thus, a money market fund which does not invest in U.S. Treasury securities, but whose investments meet the A-1 rating criteria and which maintains a weighted average maturity of 60 days or less will receive the AAAM rating just as would a Treasury MMF that maintains a weighted average maturity of 60 days or less. By contrast, a Treasury MMF or any other money market fund that maintains a weighted average portfolio maturity of between 60 and 90 days will not qualify for the AAAM rating.

Based on the foregoing, one can fairly conclude that under some circumstances AAA-rated money market funds may be safer than direct investment in U.S. Government securities. Rule 15c3-1 provides that a broker-dealer may take a zero percent haircut on investments in U.S. Government securities with less than 90 days to maturity.⁶⁵ According to S&P, in the case of a money market fund whose sole asset was a 90-day U.S. Treasury bill, it would require an overnight interest rate movement of 205 basis points or more for the fund's net asset value ("NAV") to move by more than \$0.005. By contrast, S&P believes that it would take a 306

⁶³ See *S&P MMF Ratings Criteria* at p. 3.

⁶⁴ See *id.*

⁶⁵ Rule 15c3-1(c)(2)(vi)(A).

basis point movement (*i.e.*, an additional 50%) to cause a similar NAV movement for a money market fund whose weighted average portfolio maturity was 60 days. Accordingly, a AAA-rated money market fund offers protections to the broker-dealer that are at least as great as direct investments in Treasury securities that qualify for a zero percent haircut.

Moreover, Rule 15c3-1 also provides a zero percent haircut for investments in commercial paper, bankers acceptances and certificates of deposit with less than 30 days to maturity, provided that, in the case of commercial paper, the investment is rated in the top 3 rating categories by at least two NRSROs; no rating requirement applies to bankers acceptances and certificates of deposit issued or guaranteed by a bank.⁶⁶ Again a AAAM-rated money market fund compares very favorably. Notwithstanding that the maturity of these instruments must be 30 days or less to qualify for the zero haircut (as opposed to the 60-day weighted average maturity permitted by S&P), S&P's credit standards for a AAAM-rated money market fund are higher, requiring at least 50% of the fund's investments to be in the highest gradation (A-1+) of S&P's highest short-term rating category with the balance in the second highest gradation of that category (A-1), and permitting none of the fund's assets to be in S&P's second highest short-term rating category (A-2).

A similar analysis applies under Rule 15c3-3 with respect to other forms of collateral permissible for securities lending arrangements.

- Letters of Credit -- Rule 15c3-3(b)(3)(iii)(A) provides that a broker-dealer may loan securities against, among other things "an irrevocable letter of credit issued by a bank as defined in section 3(a)(6)(A)-(C) of the [1934] Act." The rule does not impose minimum characteristics for the letter of credit or the bank that issues it. In our view, a AAAM-rated MMF compares favorably to a letter of credit issued by an unrated or lower-rated bank.
- U.S. Treasury Securities -- Rule 15c3-3(b)(3)(iii)(A) provides that a broker-dealer may loan securities against collateral that fully secures the loan of securities consisting among other things of "cash or United States Treasury bills and Treasury notes." But as we noted above, a single Treasury bill may have greater interest rate risk than a AAAM rated money market fund with its weighted average maturity of 60 days or less.

Similarly, with respect to the Special Reserve Account, Rule 15c3-3 only permits cash or "qualified securities," defined as securities issued or guaranteed as to principal and interest by the United States, to be deposited, but does not limit the

⁶⁶ Rule 15c3-1(c)(2)(vi)(E).

maturity of the qualified securities. Accordingly, AAA-rated MMFs compare favorably in that the weighted average maturity limitations would have less interest rate exposure than many qualified securities.

Finally, we note that there is nothing new about the Commission employing NRSRO ratings for net capital purposes. Chairman Donaldson recently noted in testimony before the Senate "the Commission originally used the term "Nationally Recognized Statistical Rating Organization" or "NRSRO" with respect to credit rating agencies in 1975 solely to differentiate between grades of debt securities held by broker-dealers as capital to meet Commission capital requirements."⁶⁷ Accordingly, Petitioner believes that it would be appropriate for the Commission to use the AAAm or equivalent rating as a criterion for Designated Funds.

Other Benefits of Proposed Rule Amendments

In addition, the proposed rule amendments would facilitate broker-dealers' ability to manage their cash and collateral by allowing them to delegate that responsibility to firms such as Petitioner, whose core business is to operate MMFs and to participate actively and expertly in the Treasury securities market. The Treasury securities market is widely recognized as the largest and most liquid securities market in the world.⁶⁸ Secondary market trading for Treasury securities takes place in the over-the-counter ("OTC") market. Trading activity in the OTC market takes place between primary dealers, non-primary dealers, and customers of these dealers, including financial institutions, non-financial institutions and individuals. The primary dealers are among the most active participants in the secondary market for Treasury securities. The primary dealers and other large market participants frequently trade with each other, and most of these transactions occur through an interdealer broker. The interdealer brokers provide primary dealers and other large participants in the Treasury market with electronic screens that display the bid and offer prices among dealers and allow trades to be consummated.

Smaller institutions do not have the same degree of access to the OTC market as do primary dealers and other large market participants. These institutions must use intermediaries, such as the primary dealers, to purchase and sell Treasury securities. The use of these intermediaries can be expected to result in increased transaction costs for these institutions. Permitting broker-dealers to use shares of Designated Funds in lieu of direct holdings of Government securities, Rule 15c3-3 collateral or

⁶⁷ The Honorable William H. Donaldson, Chairman, SEC, Testimony Concerning The State of the Securities Industry, Before the U.S. Senate Committee on Banking, Housing, and Urban Affairs, March 9, 2005. <http://www.sec.gov/news/testimony/ts030905whd.htm>. See also Rule 15c3-1(c)(2)(vi)(E).

⁶⁸ See The Treasury Securities Market: Overview and Recent Developments, The Federal Reserve Bulletin, December 1999, available at <http://www.federalreserve.gov/pubs/bulletin/1999/1299lead.pdf>.

qualified securities can be expected to enable such broker-dealers to manage their cash and collateral needs in a more cost-effective manner than any currently available alternative, such as by the direct purchase and sale of Treasury securities.

Similarly, even several large broker-dealers have advised Petitioner that they would prefer to delegate this responsibility to sponsors of high quality MMFs. Notwithstanding their access to the Treasury securities markets, large broker-dealers have indicated that they would rather use high quality MMFs, such as a Designated Fund, to manage their cash balances and collateral, rather than have to engage in the purchase and sale of individual Treasury securities.

Institutional Use of Money Market Funds

Money market funds now are used by institutional investors in a wide variety of applications as an efficient alternative to direct investment in Government securities. In particular, as is summarized in Exhibit B, numerous federal and state financial regulators (including the Commission), self-regulatory organizations, and state legislatures have recognized investments in shares of such funds as a fully acceptable alternative to investing in Government securities for many purposes.

Examples of such circumstances include investment of the assets of national banks (Office of the Comptroller of the Currency), state-chartered banks (Board of Governors of the Federal Reserve System and Federal Deposit Insurance Corporation), and federal credit unions (National Credit Union Administration); customer funds held in custody by futures commission merchants and futures clearing organizations (Commodity Futures Trading Commission); margin collateral (Board of Trade Clearing Corporation, New York Mercantile Exchange, Chicago Mercantile Exchange, and the Options Clearing Corporation); assets of state and municipal entities, assets subject to trust indentures, and trust and other fiduciary assets (numerous state laws). The Commission staff has authorized the pre-funded portion of an asset-backed issuance to be invested in money market mutual funds as an alternative to eligible financial assets that convert to cash.

Most recently, the Commission and the Commodity Futures Trading Commission issued joint final rules to establish margin requirements for security futures ("Final Rules").⁶⁹ The Final Rules are intended to preserve the financial integrity of markets trading security futures, prevent systemic risk, and assure that the margin requirements for security futures are consistent with the margin requirements for comparable exchange-traded option contracts.⁷⁰ The Final Rules permit the use of money market fund shares to satisfy the required margin for security futures and

⁶⁹ *Customer Margin Rules Relating to Security Futures*, Securities Exchange Act Rel. No. 46292 (Aug. 1, 2002), 67 FR 53145 (Aug. 14, 2002).

⁷⁰ *Id.*, 67 FR at 53146.

related positions carried in a securities account or futures account, subject to certain conditions.⁷¹ These conditions are intended to facilitate a security futures intermediary's hypothecation or liquidation of money market fund shares deposited as margin for security futures, as necessary to meet a customer's clearing obligations.⁷² Under the Final Rules, a security futures intermediary may accept money market fund shares as margin if the following conditions are met:

- the customer must waive any right to redeem the fund shares without the consent of the security futures intermediary and must instruct the fund or its transfer agent accordingly;
- the security futures intermediary (or clearing agency or derivatives clearing organization with which the security is deposited as margin) must obtain the right to redeem the shares in cash, promptly upon request; and
- the fund must agree to satisfy any conditions necessary or appropriate to ensure that the shares may be redeemed in cash, promptly upon request.⁷³

The ability under the Final Rules to use money market fund shares as collateral reflects a recognition by the Commission that the use of money market fund shares as collateral is consistent with the preservation of the financial integrity of markets trading security futures, and that it will not create or exacerbate systemic risk.

In addition, the Options Clearing Corporation ("OCC") has amended its rules to permit the use of money market fund shares as a form of margin collateral, provided that the fund meets specified criteria.⁷⁴ The OCC noted that it regularly reviews the forms of collateral that may be deposited as margin for suitability in order to address clearing members' desire to use a diverse combination of readily available and cost-effective forms of collateral while ensuring that collateral is limited to instruments that are relatively stable in value and are easily converted to cash.⁷⁵ The OCC expressed its belief that shares in certain money market funds meet these criteria and that it is appropriate for the OCC to expand its categories of acceptable collateral to include such instruments.⁷⁶ The OCC's view is predicated on the notion that the professional asset management, liquidity, and stable principal value typically associated with money market funds make shares in such funds an

⁷¹ *Id.*, 67 FR at 53162.

⁷² *Id.*

⁷³ *Id.*

⁷⁴ *Notice of Filing of a Proposed Rule Change Relating to Money Market Funds as Margin Collateral*, Securities Exchange Act Rel. No. 47146 (Jan. 9, 2003), 68 FR 2385 (Jan. 16, 2003) (publishing notice of filing of SR-OCC-2002-04) ("OCC Proposal").

⁷⁵ *Id.*, 68 FR at 2386.

⁷⁶ *Id.*

attractive collateral alternative for all OCC clearing accounts.⁷⁷ The Commission approved the OCC's proposal in March 2003.⁷⁸

To minimize credit risk, the OCC accepts only shares of money market funds that limit their investments to first tier securities.⁷⁹ In addition, a money market fund must make certain other agreements intended to further ensure the OCC's ability to convert fund shares promptly to cash if necessary.⁸⁰ The OCC requires a money market fund to waive its rights under the 1940 Act to delay redemption or to redeem shares in kind.⁸¹ Instead, a money market fund must agree to redeem fund shares in cash no later than the business day following a redemption request by the OCC with limited exceptions for unscheduled closings of Federal Reserve Banks or the New York Stock Exchange.⁸² These waivers of redemption restrictions along with the next day payment requirement have been established to maintain adequate liquidity of margin collateral and are also intended to be consistent with the redemption conditions contained in CFTC Rule 1.25.⁸³

The treatment accorded holdings of shares of money market funds in these circumstances recognizes that such funds offer institutions a highly efficient and convenient mechanism for managing cash balances under circumstances that offer extreme safety with infinitesimal risk.

DESCRIPTION OF PROPOSED RULE AMENDMENTS

The proposed rule amendments would extend to shares of Designated Funds the net capital treatment provided to Government securities with maturities of less than three months and the collateral treatment provided to Rule 15c3-3 collateral, and would deem Designated Fund shares to be qualified securities. A Designated Fund would be defined as a money market fund (under Rule 2a-7) that meets the following conditions:

⁷⁷ *Id.*

⁷⁸ Rel. 34-47599, 68 FR 16849 (April 7, 2003) ("OCC Approval Order"). *See also* Rel. 34-51290 approving SR-DTC-2005-02 (accelerated approval of proposed rule change to establish a setup fee for open-ended mutual funds); and Rel. 34-51289 approving SR-DTC-2005-01 (filing and immediate effectiveness of proposed rule change to make open-ended funds depository eligible).

⁷⁹ OCC Proposal.

⁸⁰ *Id.*

⁸¹ *Id.*

⁸² *Id.*, 68 FR at 2386-87. *See also* Approval Order at 68 FR at 16849.

⁸³ *Id.*, 68 FR at 2387. *See also* Approval Order at 68 FR at 16850

- the fund must have received the highest rating for a money market fund from at least one NRSRO;
- the fund would have to agree to redeem fund shares in cash, with payment being made no later than the business day following a redemption request by a shareholder, with limited exceptions for unscheduled closings of Federal Reserve Banks or the New York Stock Exchange; and
- the fund would be required to adopt a policy that it will notify its shareholders (a) of any change in its rating; or (b) 60 days prior to any change in its policy to redeem fund shares in cash no later than the business day following a redemption request by a shareholder, with limited exceptions for unscheduled closings of Federal Reserve Banks or the New York Stock Exchange.

The foregoing conditions are intended to ensure that shares of Designated Funds do not present any increased market risk, credit risk or other risks relative to direct holdings of Government securities and that the quality and liquidity of shares of Designated Funds are equivalent to the quality and liquidity of Rule 15c3-3 collateral or qualified securities.

CONCLUSION

Funds like the Prime Obligation Fund and Prime Cash Obligations Fund now have been widely approved by financial regulators, self-regulatory organizations and state legislatures for use by institutional investors as a safe and efficient alternative to direct investments in Treasury securities. Money market funds permit institutions to benefit from economies of scale that are not available when institutions attempt to manage their liquid assets directly. Money market funds, especially those that meet the definitional conditions of a Designated Fund, represent a safe, highly liquid asset with a stable value. Therefore, Petitioner respectfully requests that the Commission adopt the amendments set forth in Exhibit A that would extend to Designated Funds the same net capital treatment provided to Government securities with maturities of less than three months, the same collateral treatment provided to Rule 15c3-3 collateral, and the same Special Reserve Account treatment currently provided to qualified securities.

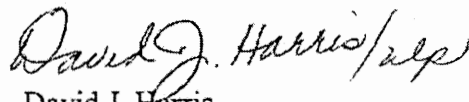
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Should you have further questions or require additional information, please do not hesitate to contact Stuart J. Kaswell at 202-261-3314 or David J. Harris at 202-261-3385.

Respectfully submitted,


Stuart J. Kaswell
Partner


David J. Harris
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Dechert LLP

Exhibits	
Letter	Description
A	Text of Proposed Amendments to Rules 15c3-1 and 15c3-3
B	Examples of when federal and state financial regulators (including the Commission), self-regulatory organizations, and state legislatures have recognized investments in money market shares as a fully acceptable alternative to investing in Government securities
C	S&P MMF Ratings Criteria.
D	Quarterly "fact sheets" for the Federated Prime Obligations Fund and the Federated Prime Cash Obligations Fund for the fiscal quarter ended December 31, 2004

cc: Hon. William H. Donaldson, Chairman
Hon. Cynthia A. Glassman, Commissioner
Hon. Harvey J. Goldschmid, Commissioner
Hon. Paul S. Atkins, Commissioner
Hon. Roel C. Campos, Commissioner

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