Investment Company Institute

2011 Money Market Funds Summit

Statement of John D. Hawke, Jr.

May 16, 2011

My name is Jerry Hawke and I am a partner at the law firm of Arnold & Porter. In recent months, I have represented Federated Investors, one of the largest managers of Money Funds in the United States, before the Financial Stability Oversight Council, the Securities and Exchange Commission, and other regulators as those entities have considered criteria for the designation of systemically significant nonbank financial institutions and have considered options for Money Fund reforms.[1] My statement covers seven key points.

The first hardly needs to be said, but it is central to the debate over regulation of Money Funds: Millions of investors – individuals, businesses, and governments – have come to rely upon the liquidity, stability, efficiency and returns provided by Money Funds.

Money Funds provide individuals with a better yield and more flexibility than bank products. They give corporate treasurers and institutional investors instant liquidity and diversification with minimal transaction costs. For balances above the $250,000 FDIC insurance

[1] Federated has served since 1974 as an investment adviser to Money Funds. Federated has more than thirty-five years in the business of managing Money Funds and, during that period, has participated actively in the development of the money market. The registration statement for Federated's Money Market Management fund first became effective on January 16, 1974, making it perhaps the longest continuously operating Money Fund to use the Amortized Cost Method. Federated also received one of the initial exemptive orders permitting use of the Amortized Cost Method in 1979.

Mr. Hawke served as United States Comptroller of the Currency from 1998 to 2004. In that capacity he also served as a Director of the Federal Deposit Insurance Corporation, the Federal Financial Institutions Examination Council, and the Basel Committee on Banking Supervision. Prior to his appointment as Comptroller, Mr. Hawke served for 3½ years as Under Secretary of the Treasury for Domestic Finance, in which capacity also he served as a director of the Securities Investor Protection Corporation (1994-1998). He also served as General Counsel of the Board of Governors of the Federal Reserve System from 1975 to 1978.

limit, money funds provide greater safety than bank deposits. They provide both business and government borrowers a significant amount of their short-term financing needs: Money Funds account for investments in almost 40% of outstanding commercial paper, approximately two-thirds of short-term state and local government debt, and a substantial amount of outstanding short-term Treasury and federal agency securities.[2] So, the question is – why do anything to change the essential character of this product and take it away from, or impair its utility for, the millions of investors and users who rely upon it?

The second point is this: If we change the essential character of Money Funds by forcing them into the banking system, as some would do – thus converting equity into debt – we would not only deprive investors of a vehicle they clearly find extremely useful, but we would overwhelm the banking system. The notion that banks could absorb significant new inflows of deposits and provide significantly more short-term financing for borrowers is purely fanciful. For banks to absorb the $2.7 trillion currently invested in Money Funds would require astronomical amounts of new equity capital to support the added leverage of the new deposits – $172 billion, given a 6% leverage requirement. With banks already under heavy pressures to increase their capital for the assets they currently carry, this would be impossible. Moreover, it would vastly increase the size of the Federal safety net to cover such a volume of new FDIC-insured deposits – not to mention the enormous amount of uninsured deposits that would be added, in large part, no doubt, at those megabanks that will be considered systemically important and too big to fail.

[2] *See* REPORT OF THE PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS, MONEY MARKET FUND REFORM OPTIONS 7, *available at* http://treas.gov/press/releases/docs/10.21%20PWG%20Report%20Final.pdf.

I would be the first to admit that, if there were a solid record of failures or losses caused by Money Funds, perhaps a different approach to regulation would be warranted. But – and this is my third point – as a former bank regulator, I look at the Securities and Exchange Commission's record of regulating Money Funds as one of the greatest regulatory success stories of all times.

In the 40-year history of money funds, only two funds ever "broke the buck" – a small fund in 1996, which returned 96 cents on the dollar, and the Reserve Primary Fund in 2008, which ultimately returned 99.2 cents on the dollar. The cost to U.S. taxpayers in connection with these incidents has been a grand total of – zero, and the impact on Money Fund shareholders has been almost imperceptible.

During that same period, over 2,800 banks failed and another 592 were kept afloat through federal bailouts, at a cost to taxpayers of more than $164 billion.[3] During the period from January 2008 through April 2011, as a result of the financial crisis caused by the burst of the housing bubble and the collapse of mortgage-backed securities investments, over 356 banks have failed,[4] and even more would have failed if the federal government had not infused about $2 trillion in cash into the banking system. Further, to get banks back on their feet, the Federal Reserve has kept interest rates close to zero, so banks can borrow at almost no cost and lend at higher rates. With interest rates so low, banks do not have to compete for depositors' funds, and

[3] FDIC Database of Failures and Assistance Transactions, *available at* http://www2.fdic.gov/hsob/SelectRpt.asp?EntryTyp=30.

[4] FDIC Failed Bank List, *available at* http://www.fdic.gov/bank/individual/failed/banklist.html.

they can afford to offer low interest rates on deposits. This is estimated to cost savers $350 billion each year.[5]

So, my fourth point is a question, albeit a rhetorical one: What caused this focus on Money Funds, and what is it that can conceivably justify major changes in regulation? The Reserve Primary Fund's repricing, which resulted from its credit losses on Lehman commercial paper, surprised an already anxious market and led to further anxiety and uncertainty on the part of other Money Fund holders that funds in which they were invested would break the buck.[6] That, of course, did not happen. To their great credit, the Federal Reserve and the Treasury understood that the underlying concern at that time was liquidity, and they implemented measured programs to provide liquidity and calm the market. There was no "bailout" of Money Funds. Indeed, no Money Fund called upon Treasury's temporary insurance program. And the Fed program was quite consistent with the role expected of the Fed in times of financial stress – to provide liquidity by making advances on the security of acceptable collateral. These temporary programs in the end yielded profits to the Fed and the U.S. taxpayers of over $1.7 billion.[7]

[5] Yalman Onaran and Alexis Leondis, *Wall Street Bailout Returns 8.2% Profit Beating Treasury Bonds*, Bloomberg (Oct. 20, 2010), *available at* http://www.bloomberg.com/news/2010-10-20/bailout-of-wall-streetreturns-8-2-profit-to-taxpayers-beating-treasuries.html.

[6] The Reserve Fund's failure, in particular, was in large part due to misconduct by its management, as the SEC has alleged in an enforcement proceeding. *See* SEC Press Release: SEC Charges Operators of Reserve Primary Fund With Fraud (May 5, 2009) (available at http://www.sec.gov/news/press/2009/2009-104.htm) and related SEC Complaint (available at http://www.sec.gov/litigation/complaints/2009/comp21025.pdf, at 35).

[7] The Treasury created a form of insurance guarantee which was never called upon, experienced no losses, and earned about $1.2 billion in participation fees. Press Release, *Treasury Announces Expiration of Guarantee Program for Money Market Funds* (Sept. 19, 2009) (*available at* http://www.ustreas.gov/press/releases/tg293.htm). The Federal Reserve created a program to provide credit for banks and bank holding companies to finance their purchases of commercial paper from Money Funds. This program terminated with no credit losses and resulted in interest income of $543 million. Federal Reserve Board, *Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility (available at* http://www.federalreserve.gov/monetarypolicy/abcpmmmf.htm); Burcu Duygan-Bump, Patrick M. Parkinson, Eric S. Rosengren, Gustavo A. Suarez, and Paul S. Willen, QAU Working

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In a real sense, Money Funds were not the cause of systemic problems, they were the victim of those problems. While Reserve undoubtedly made an improvident investment decision in its effort to reach for greater yield, mismanagement at Lehman and the government's decision to allow Lehman to fail were the root causes of the liquidity crunch. The funds that were confronted with unusually high redemptions were not suffering asset quality or credit losses. They simply faced the prospect of incurring losses on good assets that had to be liquidated prematurely to meet redemptions.

The Dodd-Frank Act attempted to identify and address the fundamental causes of the financial crisis from which we are now emerging – the most important of which, in addition to grossly imprudent mortgage lending standards and the distribution of toxic mortgage-backed securities, were ineffective risk management, excessive leverage at large, interconnected nonbank financial institutions, over-reliance on short-term funding by those firms combined with inadequate liquidity contingency plans, and a lack of regulatory tools to wind down institutions without a federal bailout. Dodd-Frank gave regulators the tools to significantly control liquidity risks and such over-reliance on short-term funding. The SEC also has taken a number of steps to bring more transparency to balance sheets with regard to short-term borrowings.[8]

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Paper No. QAU10-3, *How Effective Were the Federal Reserve Emergency Liquidity Facilities? Evidence from the Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility* (available at http://www.bos.frb.org/bankinfo/qau/wp/2010/qau1003.htm). Federal Reserve Board Press Release, FOMC Statement (Jan. 27, 2010) (*available at* http://www.federalreserve.gov/newsevents/press/monetary/20100127a.htm); Federal Reserve Bank of Boston, Financial Statements as of and for the Years Ended December 31, 2009 and 2008 and Independent Auditors' Report (*available at* http://www.federalreserve.gov/monetarypolicy/files/BSTBostonfinstmt2009.pdf).

[8] *See* Release No. 33-9143, *Short-Term Borrowings Disclosure,* 75 Fed. Reg. 59866 (Sept. 28, 2010) (proposed rules regarding disclosure of short-term borrowing practices, including balance sheet "window dressing"); Release No. 33-9144, *Commission Guidance on Presentation of Liquidity and Capital Resources Disclosures in Management's Discussion and Analysis,* 75 Fed. Reg. 59894 (Sept. 28, 2010).

The fifth point I would make is that, with the exception of the private Liquidity Exchange idea, there is not a single reform proposal that makes sense, in terms of the costs to investors versus the perceived need to wring every scintilla of risk from Money Funds. For example:

> *Why impose a floating NAV on Money Funds, and undermine the utility of the stable NAV for businesses, municipalities, and individuals?* The overwhelming majority of comments posted on the SEC's website have, after all, urged retention of the stable NAV and stressed its importance to their investments.
>
> *Why impose a capital charge on Money Funds and lower returns for both small and large investors, when Money Funds have nothing but equity capital in the first place?* The notion of a capital requirement to protect other holders of capital makes no sense. We generally think of capital as a protection for creditors, not for other equity investors. I cannot think of another instance in which government policy has required an institution to provide an equity cushion for the benefit of other holders of equity. Moreover, as we have seen, bank-style capital, the value of which is dependent on the real value of bank assets, has not been enormously successful in maintaining bank solvency when poor credit judgments or adverse market developments have caused asset values to erode. Because of the SEC-enforced limits on the kinds of investments Money Funds can make, wide swings in asset values are extremely unlikely.
>
> Even more problematic would be the creation of a non-transparent hidden capital reserve, like that used by banks in some foreign countries, rather than retaining clear

accounting standards, with Money Fund investors continuing to understand and bear the risks.

And why impose elaborate bank-style regulation and a massive supervisory apparatus on Money Funds, when it has not worked for banks? Money funds have had a stellar record with very simple and clear SEC rules.

The sixth point is that the Commission has ample existing authority to regulate Money Funds, and there is no need to add to or shift this authority. Last year, the SEC did a remarkable job of targeting specific areas of Rule 2a-7 for enhancements – such as further improving asset quality; shortening maturity limits; requiring greater diversification; enhancing disclosures – all with a view toward retaining the fundamental character of Money Funds and, most important, retaining their utility to a broad range of investors and users. In other words, the Commission managed to fine-tune its regulation, without throwing the baby out with the bathwater.

In addition to Rule 2a-7, which has been extraordinarily effective as preventative regulation, the Commission also has a broad range of authorities which enable it to step in and promptly resolve problems if and as they occur in any Money Fund. Money funds simply do not need, for example, the resolution authority of the FDIC under Dodd-Frank for systemically significant institutions, when the SEC already can –

- Require a Money Fund to immediately shift to a floating NAV if it departs from the stable NAV;

- Immediately intervene and force a court-supervised liquidation of a troubled Money Fund where the trustees are unwilling or unable to do so (a Money Fund's trustees have the initial authority to defer share redemptions and liquidate a fund in the first instance, thus treating all investors the same);

- Utilize its emergency power under Section 12(k) of the 1934 Act to act by order in an emergency with respect to any matter subject to its regulation, including investment companies;
- Use its authority under Section 25 of the Investment Company Act to intervene in respect of reorganizations and liquidations of investment companies;
- Use its cease-and-desist powers under Section 9(f) of the Investment Company Act;
- Obtain injunctive relief under Sections 36 and 40(d) of the Investment Company Act;
- Impose civil money penalties on Money Funds and their related persons under Sections 9(d) and 40(e) of the Investment Company Act;
- Bring a judicial action and invoke the Federal courts' 1934 Act § 21(d)(5) equitable remedies powers; and
- Bring a judicial action and petition the Federal court to invoke the All Writs Act powers to enjoin other proceedings that interfere with the court's jurisdiction over the matter.[9]

[9] 28 U.S.C. § 1651.

The only "tool" the Commission lacks is the deep pocket of taxpayer funds to bail out an institution. And after Dodd-Frank, that tool may no longer be used – by any regulator, for any institution.

A final point: as part of the rulemaking process under Dodd-Frank, regulators have put forward, and Federated has filed comments on, a number of proposals regarding the designation, regulation, and resolution of systemically significant nonbank financial institutions.[10] For the reasons detailed in those letters, designation of Money Funds as "systemically significant" under section 113 of Dodd-Frank would not be appropriate, nor should the FSOC direct the SEC to change the way Money Funds are regulated.

The one proposal that makes some sense with regard to further enhancements of Money Funds is that raised in the PWG report for providing Money Funds with access to reliable, private emergency liquidity facilities. The Investment Company Institute, working with its members, including Federated, has offered the idea of a Liquidity Exchange Facility for all prime funds.[11] The Liquidity Exchange Facility would be chartered as a state bank or trust company, capitalized and funded entirely by the Money Fund industry. It would serve as a source of liquidity in times of market distress, and therefore is directly responsive to the situation presented in September 2008.

[10] *See e.g.*, Letter to the Federal Deposit Insurance Corporation (Mar. 28, 2011) (attached).

[11] "Prime" funds are those that invest in high-quality short term money market instruments including Treasury and government obligations, certificates of deposit, repurchase agreements, and commercial paper, but do not include tax-exempt, Treasury or government Money Funds. The Investment Company Institute's ("ICI's") proposal for a private liquidity facility would be limited to prime funds. Due to their underlying assets, tax-exempt, Treasury or government Money Funds are not subject to the same credit risk profile as prime funds. Indeed, as reported by the ICI, investors actually shifted substantial sums from prime Money Funds to government Money Funds in September 2008 ("[I]nvestors redeemed $396 billion from prime money market funds and invested $294 billion in government money market funds from September 10, 2008 to October 1, 2008."). Letter from Paul Schott Stevens, ICI, to Elizabeth Murphy, dated January 10, 2011) (*available at* http://www.sec.gov/comments/4-619/4619-49.pdf).

In the end, however, the case has not been made for changing a formula that has worked. Money Funds are effectively governed by liquidity and asset quality standards under Rule 2a-7 and Commission oversight. It certainly does not make sense to subject them to bank-like regulation, or to alter their fundamental characteristics in any way. Moreover, the SEC has recently strengthened Rule 2a-7, and there seems to be no pressing reason for immediate large-scale reforms. If any reforms are pursued, consideration should be given to the ICI’s suggestion of a new private liquidity facility. This would be the most effective means to allow Money Funds to continue to serve the needs of businesses, state and local governments, and other investors. The investors have clearly stated that they want the SEC to maintain the simple approach that has worked extremely well for Money Funds. At a time when the federal budget is constrained, imposing on Money Funds the bank regulatory approach of tens of thousands of on-site government examiners and tens of thousands of pages of laws and regulations – which has not worked to keep banks solvent – is not a realistic option.

ARNOLD & PORTER LLP

John D. Hawke, Jr.
John_Hawke@aporter.com

202.942.5908
202.942.5999 Fax

555 Twelfth Street, NW
Washington, DC 20004-1206

March 15, 2011

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

Re: File No. 4-619; Release No. IC-29497 President's Working Group Report on Money Market Fund Reform; Supplemental Comment of Federated Investors, Inc. in Response to Comment of Mr. Paul A. Volcker

Dear Ms. Murphy:

We are writing on behalf of our client, Federated Investors, Inc. and its subsidiaries ("Federated"), to provide a supplemental comment in response to the U.S. Securities and Exchange Commission's (the "Commission's") request for comments on the President's Working Group Report on Money Market Fund Reform. We supplement Federated's earlier comments submitted in this docket in order to respond to a comment letter filed after the close of the comment period by Mr. Paul Volcker.[1] Federated has served since 1974 as an investment adviser to money market mutual funds ("Money Funds").[2] We appreciate the opportunity to submit this supplemental comment letter.

In his letter, Mr. Volcker argues for fundamental change to the regulation and structure of Money Funds based on three premises, each of which is clearly erroneous:

(1) Money Funds "*promise*" investors that they will maintain a stable net asset value (NAV) per share;

[1] Letter from Paul A. Volcker (Feb. 11, 2011).

[2] Federated has more than thirty-five years in the business of managing Money Funds and, during that period, has participated actively in the money market as it has developed over the years. The registration statement for Federated's Money Market Management fund first became effective on January 16, 1974, making it perhaps the longest continuously operating Money Fund to use the Amortized Cost Method. Federated also received one of the initial exemptive orders permitting use of the Amortized Cost Method in 1979.

(2) Money Funds do not have equity capital or liquidity standards; and

(3) Money Funds are not regulated.

On the first point, Money Funds very clearly and very specifically *Do Not Promise* to maintain a stable net asset value. Quite the opposite is true. In both prospectuses and marketing literature, Money Funds specifically state that their values are not guaranteed and may fluctuate. For example, the marketing literature for the Federated Prime Cash Obligations Money Fund states:

"An investment in money market funds is neither insured nor guaranteed by the Federal Deposit Insurance Corporation or any other government agency. Although money market funds seek to preserve the value of your investment at $1.00 per share, it is possible to lose money by investing in these funds."

Similarly, in addition to providing a list of ways the fund could lose money or break a buck, the prospectus for the Federated Prime Cash Obligations Money Fund states on pages 2-4 that:

> "All mutual funds take investment risks. Therefore, even though the Fund is a money market fund that seeks to maintain a stable NAV, it is possible to lose money by investing in the Fund.... The Shares offered by this Prospectus are not deposits or obligations of any bank, are not endorsed or guaranteed by any bank and are not insured or guaranteed by the U.S. government, the Federal Deposit Insurance Corporation, the Federal Reserve Board or any other government agency."

This language is not unique to Federated's Money Funds, it is required in the marketing literature and prospectuses of *all* Money Funds by both SEC and FINRA rules and interpretations.[3] The Federated Prime Cash Obligation Money Fund's Prospectus further describes the risk that it may not be able to maintain a stable net asset value:

[3] SEC Form N-1A, Item 4(b)(ii) & (iii) ("Principal risks of investing in the fund"). Form N-1A was adopted by the SEC as a formal rule under the notice and comment process of the Administrative Procedures Act and has the binding force of a federal regulation. FINRA Notice to Members No. 08-82 (2008), FINRA/NASD Rule 2210 and IM-2210-1 (brokerage firms must disclose to investors that it is

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> In the unlikely event that the Fund's Board were to determine, pursuant to Rule 2a-7, that the extent of the deviation between the Fund's amortized cost per share and its market-based NAV per share may result in material dilution or other unfair results to shareholders, the Board will cause the Fund to take such action as it deems appropriate to eliminate or reduce, to the extent practicable, such dilution or unfair results, including, but not limited to, considering suspending redemption of Shares and liquidating the Fund under Rule 22e-3 under the Investment Company Act of 1940. ....There is no guarantee that the Fund will provide a certain level of income or that any such income will exceed the rate of inflation. Further, the Fund's yield will vary. A low interest rate environment may prevent the Fund from providing a positive yield or paying Fund expenses out of current income and could impair the Fund's ability to maintain a stable NAV.... The Fund attempts to stabilize the NAV of its Shares at $1.00 by valuing the portfolio securities using the amortized cost method. In addition, for regulatory purposes, the Fund calculates a market-based NAV per Share on a periodic basis. The Fund cannot guarantee that its NAV will always remain at $1.00 per Share.

For a Money Fund to state that it will attempt to maintain a stable NAV, but that it may not in all circumstances be able to do so, and that investors may as a result lose money, is very different from a promise to maintain a stable NAV. When, due to market conditions or otherwise, Money Funds are not able to maintain a stable net asset value based upon current market values of their portfolio assets, Money Funds are required by Rule 2a-7 to immediately switch to a floating NAV. The marketing literature and prospectuses of Money Funds warn shareholders that this could happen.

On the second point, of course Money Funds have equity capital. In fact they *only* have equity capital. Money Funds do not use leverage or debt. They are financed entirely by equity capital from their investor/shareholders. Money Funds also have far more stringent liquidity standards than do banks. Unlike banks, all portfolio assets of a Money Fund must be highly liquid, high quality short term debt instruments. If the portfolio assets of a Money Fund decline in value, there is no problem repaying lenders, because there are none. Instead, the Money Fund is required to mark its assets to market,

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possible to lose money with an investment in a Money Fund). *See also*, Federal Reserve, FDIC, OCC, OTS, Interagency Statement on Retail Sales of Non-deposit Investment Products (Feb. 1994).

the Money Fund "breaks a buck" and shareholders get back something less than 100 cents on the dollar. In the 40 years that Money Funds have existed, that has happened only twice. In one case shareholders got back 96 cents on the dollar. In the other, shareholders got back more than 99 cents on the dollar. And in neither case did taxpayers foot the bill.

If what Mr. Volcker means is that Money Funds should be required to maintain a class equity capital that is subordinated to the claims of Fund shareholders -- capital presumably furnished by Fund sponsors -- it would mark an extraordinary intrusion by government into equity markets. We can think of no other situation in which holders of equity, which is what Money Fund shareholders are, are provided with governmentally-mandated protection in the form of a subordinated form of equity.

On the third point, Money Funds are, of course, comprehensively regulated and supervised by the Commission under the Investment Company Act, Rule 2a-7 and other federal securities laws and regulations. What Mr. Volcker can only mean is that Money Funds are not regulated by the Federal Reserve, unlike the more than 2800 insured depository institutions that were regulated by the Federal Reserve and its sister federal banking agencies, prior to their failures over the four decades since Mr. Volcker first spoke out against Money Funds during his tenure as Chairman of the Board of Governors of the Federal Reserve System.

Drawing upon arguments built on his false premises, and a variety of other inaccurate assertions, Mr. Volcker goes on to advocate doing away with Money Funds as we currently know them.

> I feel the natural and predominant destination for investors that seek secure, stable value, interest bearing financial products is the banking system.... Thus an important potential benefit to the financial system as a result of applying new regulations of this type to MMMFs would be a banking system funded by an increased amount of stable, lower cost deposits. This is not an insignificant factor to consider at a time when banking participation will be important to a restructuring of the residential mortgage market.

Essentially, Mr. Volcker wants to forcibly transfer nearly three trillion dollars of private investor money from Money Funds into the banking system.

We see two major flaws with Mr. Volcker's proposal: Even at the 20-1 leverage ratios permitted at banks, this transmutation of Money Fund shareholder balances into bank deposits would require roughly $150 billion in new equity capital at bank. One must ask where that new capital would come from, particularly at a time when bank capital is under enormous stress. Second, such a forced transfer would have a profound impact both on investors in Money Funds and on the markets for short-term corporate and government debt, which are presently supported in large part by the Money Fund industry.

We appreciate the opportunity to submit this supplemental comment letter on the Report of the President's Working Group on Money Market Fund Reform.

Sincerely,

John D. Hawke, Jr

John D. Hawke, Jr.

ARNOLD & PORTER LLP

John D. Hawke, Jr.
John_Hawke@aporter.com

202.942.5908
202.942.5999 Fax

555 Twelfth Street, NW
Washington, DC 20004-1206

February 24, 2011

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

Re: File No. 4-619; Release No. IC-29497 President's Working Group Report on Money Market Fund Reform; Supplemental Comment of Federated Investors, Inc. in Response to Comment of The Squam Lake Group

Dear Ms. Murphy:

We are writing on behalf of our client, Federated Investors, Inc. and its subsidiaries ("Federated"), to provide a supplemental comment in response to the U.S. Securities and Exchange Commission's (the "Commission's") request for comments on the President's Working Group Report on Money Market Fund Reform. We supplement Federated's earlier comments submitted in this docket in order to respond to a comment letter filed after the close of the comment period by The Squam Lake Group (the "Squam Letter"), which is a consortium of academic economists.[1] Federated has served since 1974 as an investment adviser to money market mutual funds ("Money Funds").[2] We appreciate the opportunity to submit this supplemental comment letter.

We agree with the Squam Letter on one major point: moving Money Funds to a floating NAV is a fundamentally unsound idea that, if acted upon, would not only make Money Funds unattractive to investors, it would also significantly increase systemic risk in the banking industry. This view, that moving Money Funds to a floating NAV would be a very bad idea, is also shared by a broad cross section of other commenters

[1] Letter from Professor René M. Stulz, PhD., on behalf of the Squam Lake Group (Jan. 14, 2011).

[2] Federated has more than thirty-five years in the business of managing Money Funds and, during that period, has participated actively in the money market as it has developed over the years. The registration statement for Federated's Money Market Management fund first became effective on January 16, 1974, making it perhaps the longest continuously operating Money Fund to use the Amortized Cost Method. Federated also received one of the initial exemptive orders permitting use of the Amortized Cost Method in 1979.

representing consumers and investors,[3] academia,[4] businesses,[5] business journalists,[6] state and local governments,[7] and investment management firms.[8]

We disagree with the Squam Letter, however, on two other basic points: (1) the premise of the Squam Letter that the current way in which Money Funds are structured and regulated is flawed and creates systemic risk; and (2) the conclusion of the Squam Letter that there is a need to fundamentally change the capital structure of Money Funds to address the alleged systemic risk.

[3] Letters from the American Association of State Colleges and Universities; the Port of Houston Authority; Cincinnati/Northern Kentucky International Airport; Treasurer of the State of New Hampshire; Tom Welch. *Accord*, Letter from Consumer Federation of America and Fund Democracy (Sept. 8, 2009) (in Commission comment docket for Rule 2a-7 amendments, S7-11-09).

[4] Paper submitted by Professor Jonathan Macey, *Reducing Systemic Risk: The Role of Money Market Mutual Funds as Substitutes for Federally Insured Bank Deposits*, at 58-62.

[5] Letters from the Business Council of New York State; Dallas Regional Chamber; Associated Industries of Florida; New Jersey Chamber of Commerce. *See also* letter from the following businesses and associations: Agilent Technologies, Inc.; Air Products & Chemicals, Inc.; Association for Financial Professionals; The Boeing Company; Cadence Design Systems; CVS Caremark Corporation; Devon Energy; Dominion Resources, Inc.; Eastman Chemical Company; Eli Lilly & Company; Financial Executives International's Committee on Corporate Treasury; FMC Corporation; Institutional Cash Distributors; Kentucky Chamber of Commerce; Kraft Foods Global, Inc.; National Association of Corporate Treasurers; New Hampshire Business and Industry Association; Nissan North America; Pacific Gas and Electric Company; Safeway Inc.; Weatherford International; U.S. Chamber of Commerce.

[6] Letter from Crane Data, LLC.

[7] Letters from the Port of Houston Authority; Cincinnati/Northern Kentucky International Airport; Treasurer of the State of New Hampshire. *See also* letter filed by following associations of state and local entities: the American Public Power Association; the Council of Development Finance Agencies; the Council of Infrastructure Financing Authorities; the Government Finance Officers Association; the International City/County Managers Association; the International Municipal Lawyers Association; the National League of Cities; the National Association of Counties; the National Association of Local Housing Financing Agencies; the National Association of State Auditors, Comptrollers and Treasurers; the National Association of State Treasurers and the U.S. Conference of Mayors ("State and Local Entities Letter").

[8] Letters from Vanguard; UBS Asset Management; Goldman Sachs Asset Management; Dreyfus Corporation; JP Morgan Asset Management.

On the first point, the Squam Letter notes that during the financial crisis, one Money Fund, the Reserve Primary Fund, broke a buck and was forced to halt redemptions and liquidate. The Squam Letter goes on to note that 36 other Money Funds received financial support from their sponsors, with the levels of support of these 36 funds depicted in a bar chart. From this, the Squam Letter posits that there is a systemic risk posed by Money Funds.

We see these numbers in a very different way. As of the beginning of 2008, there were 807 Money Funds in existence.[9] Of these 807 Money Funds, 771 -- over 95% -- did not receive any financial support from their sponsors. Moreover, of these 807 Money Funds, 806 did *not* break a buck during the worst financial crisis since the Great Depression. In other words, roughly 99.9% of Money Funds did *not* break a buck during a financial crisis the likes of which most of us had never before seen. The Reserve Primary Fund, the *only* Money Fund to break a buck, was liquidated and it shareholders received back 99.2% of their money. And *none* of these Money Funds or their shareholders received a federal bail-out. That is not simply good performance. That is phenomenally good performance, during a period of near economic chaos.

The sudden collapse of Lehman Brothers and the weakness of a number of other large financial firms that were major issuers of commercial paper caused the problem in the money markets in September 2008 and caused the Reserve Primary Fund to break a buck. Money Funds did not cause the problems at the issuers or in the money markets, but instead experienced redemptions and credit quality concerns that reflected the problems at commercial paper issuers. Those concerns over the issuers of commercial paper led to illiquidity in the money markets in 2008, much as was the case in 1974 when Penn Central defaulted on its commercial paper obligations.

Changing the capital structure of Money Funds would do nothing to address credit quality or liquidity issues among the issuers of commercial paper and the impact that problems at one or more major issuers can cause to the money markets as a whole. However, the focus in Title I of the Dodd Frank Act on improving the transparency, capital and liquidity standards of significant bank and nonbank financial firms that are major commercial paper issuers, and the actions that the regulators will take to implement those requirements, will have the beneficial effect of reducing risk and increasing

[9] Investment Company Institute, 2008 Investment Company Factbook, Table 34.

stability in the money markets. Greater stability among the major issuers of commercial paper into the money markets will translate into lower risks at Money Funds.

We note that an additional destabilizing factor, which has been largely overlooked in the discussion, was an increase in deposit insurance limits and a competing money management deposit product introduced suddenly by Congress and the FDIC in the midst of the crisis. On October 3, 2008, Congress temporarily increased deposit insurance coverage for all bank depositors to $250,000 (up from $100,000), and on October 13, 2008, the FDIC issued an unlimited federal insurance guarantee of bank deposits bearing an interest rate of 0.5% (a rate defined in the FDIC rules as "noninterest bearing," but that was actually a very competitive rate at the time for federally-insured money) or less.[10] Money Funds are attractive to persons with cash balances in excess of the federal deposit insurance limit. Many sophisticated investors believe there is far greater risk in holding a bank deposit in excess of the deposit insurance limit than in holding shares of an entirely uninsured Money Fund, due to the more stringent portfolio requirements, transparency, and absence of interest rate risk at a Money Fund. The FDIC took the extraordinary step of granting unlimited deposit insurance in order to stabilize funding of banks, many of which were facing a liquidity crunch of their own. But an unintended consequence of the FDIC's sudden move was to establish a risk-free, higher yielding cash management product without a dollar cap, which without the temporary Treasury Department guarantee program for Money Funds described below would have created a financial incentive for sophisticated money managers and investors to move cash from Money Funds to banks. The Treasury in response to the crisis in late September 2008 announced a new program for a Treasury guarantee of shareholders of Money Funds that opted in, but it was far more limited than the FDIC's unlimited bank deposit insurance and covered only Money Fund investor balances in existence prior to September 20, 2008. The Treasury's Money Fund guarantee program expired in September 2009, without a single claim being made upon it, and the substantial premiums paid by Money Funds to the Treasury in connection with that program were profitable to Treasury.

The stable performance of Money Funds during the recent financial crisis is consistent with how stable Money Funds have been over the entire 40 years that there have been Money Funds. Since 1971, only two Money Funds have broken the buck --

[10] See FDIC Press Release: *FDIC Board of Directors Approves TLGP Final Rule* (Nov. 21, 2008) (available at http://www.fdic.gov/news/news/press/2008/pr08122.html).

the Reserve Primary Fund mentioned above, and the Community Bankers U.S. Government Fund, a small institutional fund that broke the buck in 1994 and on which investors received back 96 cents on the dollar. During that 40-year period, roughly $335 trillion in investor balances have flowed through Money Funds, with no federal bail-outs of Money Funds.

Now let us compare that record with the solvency records of banks during the same period. Since 1971 over 2,800 banks have failed, and an additional 592 were kept afloat through federal bailouts, at a total cost to the federal government of over $164 billion.[11] During the financial crisis, from January 2008 through February 18, 2010, 344 banks failed in the United States. Keep in mind that U.S. banks are policed by an army of 26,000 federal bank regulators[12] divided among four (formerly five) agencies, plus 50 state bank regulators, and are subject to 14 weighty volumes of federal banking statutes and regulations totaling many thousands of pages of small print, plus state banking laws and regulations, governing all aspects of their operations, including elaborate capital and liquidity standards. An observer might reasonably conclude that the regulatory approach taken to maintain the solvency and stability of banks is not working very well.

Yet, surprisingly, the Squam Letter proposes a "solution" to the "problem" at Money Funds in the form of an entirely new capital structure that looks like, well, the capital structure of banks. But without FDIC insurance. The proposal is reminiscent of the program for maintaining the solvency of banks before the creation of the FDIC in 1934. In essence, the Squam Letter proposal is to instill confidence in Money Fund investors that their investments are safe from loss by requiring Money Fund sponsors to hold a class of junior capital amounting to a few percent of each Money Fund, that will absorb portfolio losses without impacting the rest of the Money Fund's investors. The Squam Letter suggests that this small capital cushion will reassure Money Fund investors and prevent future "runs;" and make them think of themselves like depositors. This approach has not worked well at banks and there is no reason to believe it would work at Money Funds.

[11] FDIC Failed Bank List (*available at* http://www.fdic.gov/bank/individual/failed/banklist.html); FDIC Database of Failures and Assistance Transactions (*available at* http://www2.fdic.gov/hsob/SelectRpt.asp?EntryTyp=30).

[12] FDIC 2009 Annual Report, Federal Reserve 2009 Annual Report, OCC 2009 Annual Report, OTS 2009 Annual Report.

First, the most immediate problem during the financial crisis, as in the start of the Great Depression, was not asset quality. It was liquidity. A few percentage points of junior capital does little or nothing to address liquidity problems. Instead, maintaining a short-term fixed income portfolio, which holds a large chunk of ready cash and near-cash assets and essentially self-liquidates in its entirety in a relatively short period of time, provides a much better protection against a "run." This is the approach taken by the SEC in Rule 2a-7, and these liquidity requirements have been made even more stringent through the 2010 amendments to that rule.[13]

Second, the Squam Letter proposal would transform shareholders of Money Funds essentially into depositors or creditors, who are protected against loss by a small, more junior class of shareholder, and who would not share in any upside yield. This essentially would introduce a form of leverage to Money Funds for the first time. Currently, Money Funds have 100% equity capitalization. Shareholders are not guaranteed against losses. Instead, they are very clearly told that, although the fund will attempt to maintain a stable net asset value per share (generally $1 or $10 per share) there is no guarantee that it will be able to do so, and are told very clearly that there is no federal guarantee of the value of their shares. This creates an incentive for investors not to chase yield, but instead to consider the quality of the investment portfolio of the Money Fund. The absence of a junior class of securities also reduces the incentive for the sponsor as the holder of that junior class to pursue a higher risk portfolio investment strategy in order to increase the residual return to the junior class of equity after paying the senior investor class its yield, the way, for example, that bankers and hedge fund sponsors do.

Money Funds are not able to maintain stable net asset value simply because a Commission rule says they can, or due to sponsor support. Creating a new junior class of capital would not enhance the mechanism by which Money Funds are able to maintain stable net asset value per share. Money Funds are usually successful in their attempt to maintain a stable net asset value per share due to the very tight restrictions on their investment portfolios which greatly reduces both interest rate risk and default risk in the underlying portfolio. Within these limits, the value of the portfolio assets are very resilient, and can quickly be converted to cash at par value through sale or near term maturity. But Money Funds are also required to calculate the floating NAV per share,

[13] SEC Rel. No. IC-29132, *Money Market Fund Reform*, 75 Fed .Reg. 10060 (Mar. 4, 2010).

and if it diverges to any significant degree from the stable net asset value, to immediately shift to a floating net asset value, and if necessary, to suspend redemptions and promptly liquidate.[14] When that happens (as noted above it has happened only twice in forty years) investors share in the loss, but they get back almost all of their money, and they get it back quickly.

We also note that the capital structure proposed by the Squam Letter also bears a striking resemblance to the capital structures formerly used for asset securitization and structured finance vehicles. These vehicles typically had a junior capital structure in roughly the same small percentages suggested for Money Funds by the Squam Letter, a second senior equity tranche, and several senior equity or debt tranches above it that were rated investment grade by the rating agencies. Those vehicles failed dramatically during the recent financial crisis. It is not clear why the authors of the Squam Letter would resurrect that structure as a model for Money Funds, although we note that the complex securitization vehicle capital structure, like the one proposed here by the Squam Letter for Money Funds, was developed by academics and rating agencies.[15]

Finally, we note that the general thrust of the Squam Letter proposal is a variation on the theme of increased sponsor support of Money Funds as a means to reduce the investment concerns of risk-averse investors, a position that has been championed by one of the rating agencies.[16] A major goal of financial reform is to reduce systemic risk. Tying the solvency of Money Funds to sponsor support for those funds as a means to reduce the concerns of risk-averse investors, is fundamentally the wrong direction to go in order to reduce systemic risk.[17]

[14] The Squam Letter suggests that Money Fund shareholders will get advance notice of an impending switch to floating NAV and will have an incentive to pull their money out to avoid the loss, thereby triggering a run. The Commission has a rule for that. 17 C.F.R. § 240.10b-5.

[15] *See* fn * on page 1 of Squam Letter.

[16] *See* Emily Flitter, *Moody's Drops One Money Fund Rating Method Change*, Reuters (Jan. 24, 2011) (available at http://www.reuters.com/article/2011/01/24/markets-money-idUSN2418535620110124).

[17] *See* Letter from Ben S. Bernanke, Chairman, Board of Governors of the Federal Reserve System, to Anthony J. Carfang (Dec. 9, 2010); Letter from John Walsh, Acting Comptroller of the Currency, to the Honorable Gregory W. Meeks (Feb. 17, 2011), copies of which are attached hereto.

We appreciate the opportunity to submit this supplemental comment letter on the Report of the President's Working Group on Money Market Fund Reform.

Sincerely,

John D. Hawke, Jr.

John D. Hawke, Jr.

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

BEN S. BERNANKE
CHAIRMAN

December 9, 2010

Mr. Anthony J. Carfang
Partner
Treasury Strategies, Inc.
309 W. Washington Street – 13th Floor
Chicago, Illinois 60606

Dear Mr. Carfang:

Thank you for your letter expressing your concerns about a new rating system for money market funds proposed by Moody's Investor Services that involves an assessment of "a fund sponsor's ability and willingness to support a financially stressed fund."

In its recent report on "Money Market Fund Reform Options" (released on October 21, 2010), the President's Working Group on Financial Markets (PWG), of which I am a member, recognized that discretionary financial support from sponsoring institutions raises a number of important policy issues.[1] In particular, the PWG report noted that uncertainty among investors about the actual availability of discretionary support during crises may contribute to the vulnerability of money market funds to "runs"--that is, to large, destabilizing redemption requests from investors that may spread quickly through the industry. While emphasizing that money market funds and their investors have several characteristics that increase this vulnerability, the report found that a history of discretionary financial support may have helped foster the perception that money market funds are very safe investment vehicles and, thus, may have attracted highly risk-averse investors who are particularly prone to flight when they perceive the possibility of a loss. In light of the report's findings, an evolution in market conventions that might reinforce this dynamic is of concern, and I believe it is important to address sponsor support of money market funds in the broader context of reforms that can make the funds less vulnerable to runs.

The PWG report framed a number of policy options that might help mitigate the susceptibility of money market funds to runs, including options that could materially change the nature of sponsor support for such funds. The PWG requested that the Financial Stability Oversight Council (FSOC), of which I am a member, consider these policy options and pursue

[1] The report can be found on the U.S. Department of the Treasury's website, http://treas.gov/press/releases/docs/10.21%20PWG%20Report%20Final.pdf
The President's Working Group on Financial Markets comprises Treasury Secretary Geithner, Chairman Shapiro of the Securities and Exchange Commission, Chairman Gensler of the Commodity Futures Trading Commission, and me as Chairman of the Board of Governors of the Federal Reserve System.

the implementation of those deemed most likely to materially reduce funds' susceptibility to runs. I expect the FSOC to carry out this request.

To assist the FSOC in any analysis, the Securities and Exchange Commission (SEC), in its role as the primary regulator of money market funds, is soliciting public comments on the options described in the PWG report as well as on the broader policy issues raised by the vulnerabilities of money market funds. I would encourage you to submit your comments about discretionary sponsor support and Moody's intended rating system to the SEC so that these views may be considered by all members of the FSOC in their deliberations. Instructions for submitting public comments are available on the SEC's website, at http://www.sec.gov/rules/other/2010/ic-29497.pdf.

Sincerely,

Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

February 17, 2011

The Honorable Gregory W. Meeks
2342 Rayburn House Office Building
Washington, DC 20515-3461

Dear Representative Meeks:

Thank you for your letter of December 17, 2010, regarding Moody's proposal to change its rating methodology for money market mutual funds (MMFs). You asked that we clarify for you what impact the Moody's proposal could have on banks, their sponsored MMFs, and the financial system more broadly, if bank sponsors were to implicitly or explicitly indicate, and ultimately have to provide, support to these MMFs. You also asked what we have communicated to banks on this subject to date.

As your letter noted, Moody's recently proposed to include as a major factor in its rating assignment the likelihood and ability of a sponsor to support a MMF should the fund run into difficulties. As you may be aware, on January 18, 2011, Moody's issued an update to their proposed money market fund rating methodology in which they announced, in response to comments on their proposal, that they would redesign their methodology for rating MMFs to reflect a fund's own characteristics rather than focus upon the sponsor of the fund.[1] Moody's noted that some had expressed concern over its intention to consider sponsorship as a factor in the proposed MMF ratings. In particular, Moody's noted:

> These respondents argued that despite a long history of sponsor support as a critical factor in preserving MMF stability, future support is less certain, assessment of sponsors involves judgment and [Moody's] considering sponsorship could cause investors to over-rely on sponsors' implicit support for their funds.

Moody's update notes that their revised methodology "is re-designed to reflect a fund's own characteristics and thus strong sponsorship will not enhance a fund's rating." Nonetheless, Moody's observes that "the quality of a fund's sponsor will continue to be a factor in our ratings, including our expectation that funds rated in the top category (Aaa-mf) would be sponsored by firms having an investment-grade or equivalent credit profile."

[1] Moody's Investors Service, Global Credit Research Announcement (January 18, 2011) Moody's: *Update on Money Market Fund Ratings Methodology*.

Under its proposal, in order to receive Moody's top rating, Moody's assessment was to focus not only on whether the fund sponsor is highly creditworthy, but would also consider the sponsor's willingness to provide support to the MMF.[2] Moody's does not define which entity they consider to be the "sponsor" of a MMF. As the regulator of national banks, the OCC is in a position to offer our observations to the extent that the Moody's proposal may treat a national bank as a "sponsor" of a MMF.

Because of both safety and soundness and legal concerns raised by the prospect of a bank providing financial support to a MMF or other investment funds, on January 5, 2004, the Federal banking agencies issued the *Interagency Policy on Banks/Thrifts Providing Financial Support to Funds Advised by the Banking Organization or its Affiliates* (Interagency Policy).[3] The banking agencies were concerned that a bank's support to a fund could: (1) inappropriately place the bank's resources and reputation at risk for the benefit of the fund's investors and creditors; (2) violate the limits and requirements contained in sections 23A and 23B of the Federal Reserve Act and Regulation W, as well as other applicable legal requirements and other special supervisory conditions imposed by the agencies; and (3) create an expectation that the bank would prop up the advised fund. Banks were advised that because of the potential risks posed by the provision of financial support to advised funds, that bank management should notify and consult with their appropriate federal banking agency prior to (or immediately after, in the event of an emergency) the bank providing material financial support to its advised funds. We would then scrutinize the circumstances surrounding the transaction and address situations that raise supervisory concerns. Accordingly, even in cases where a national bank may otherwise be willing to provide support to a sponsored fund, the OCC can restrict them from doing so for legal or safety and soundness reasons.

We believe, consistent with the 2004 Interagency Statement, that banking companies should continue to have the ability, in limited circumstances, to provide support to their sponsored MMFs, particularly where this support comes from the bank holding company rather than the bank. However, as indicated above, we are opposed to any policy that creates an expectation that a national bank will be relied upon to provide support to a sponsored fund.

I hope this information is helpful. If you would like to discuss this further, please do not hesitate to contact me or John Hardage, Director of the OCC Congressional Liaison Office, at (202) 874-1881.

Sincerely,

John Walsh

John Walsh
Acting Comptroller of the Currency

[2] Moody's Investors Service Request for Comment, *Moody's Proposes New Money Market Fund Rating Methodology and Symbols* (September 7, 2010), pp. 13-14.

[3] http://www.occ.gov/news-issuances/bulletins/2004/bulletin-2004-2a.pdf