

STATEMENT OF J. CHRISTOPHER DONAHUE
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FEDERATED INVESTORS, INC.

SUBMITTED TO THE

Committee on Banking, Housing and Urban Affairs

UNITED STATES SENATE

ON

“PERSPECTIVES ON MONEY MARKET MUTUAL FUND REFORMS”

June 21, 2012

Chairman Johnson, Ranking Member Shelby, Members of the Committee, I want to thank you for providing me the opportunity to appear at today’s hearing. I am the President and CEO of Federated Investors, Inc. (“Federated”), the third largest manager of money market funds (“MMFs”) in the United States. Our MMFs currently have assets of approximately \$240 billion, with millions of individual and thousands of institution shareholders for whom we provide investment management, including corporations, government entities, insurance companies, foundations and endowments, banks and broker-dealers. Federated has 1450 employees.

Federated has provided extensive data and commentary to the Securities and Exchange Commission (“SEC”), in response to its request for comments on the Report of the President’s Working Group on Financial Markets regarding possible changes to MMFs (the “PWG Report”)¹ and to the Financial Stability Oversight Council (“FSOC”) and banking regulators in connection with rulemaking proposals to implement Titles I and II of the

¹ The PWG Report was published for comment in Release No. IC-29497, President’s Working Group Report on Money Market Funds (Nov. 3, 2010), available at <http://www.sec.gov/rules/other/2010/ic-29497.pdf>.

Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”). A list of links to Federated’s comment letters is included at the end of my statement.

We are concerned that, based upon recent speeches by the SEC Chairman and a number of members of the Federal Reserve Board, key regulators have largely disregarded the comments received in response to the PWG Report—not only Federated’s comments, but also others who pointed out errors underlying, obstacles to and unintended consequences of possible reforms. More disturbingly, although as of this date neither the SEC nor FSOC have proposed rules or other action specifically targeting MMFs, key members of both agencies have continued to pursue reform proposals heedless of the PWG Report’s important warning that “[a]ttempting to prevent any fund from *ever* breaking the buck would be an impractical goal that might lead... to draconian and—from a broad economic perspective—counterproductive measures”² Their attempt to eliminate risk from MMFs has resulted in draconian proposals that would eliminate MMFs, if not altogether, then as a meaningful component of the U.S. cash markets.

Let us remember that money market funds did not cause the recent financial crisis.³ They were simply not immune to the largest financial crisis since the Great Depression. Yet instead of targeting the causes of the crisis, the SEC Chairman and certain members of the FSOC have threatened ill-conceived reforms whose demonstrable costs far outweigh any plausible benefits. Indeed, even the existence of a benefit from the proposals being discussed is debatable when a full accounting of the impact on the banking system and the expansion of the Federal safety net are taken into account. The flawed process leading to this outcome—where bank regulators now dictate the content of securities law without meaningful dialog with those affected or serious study of unintended consequences—does

² PWG Report at 13.

³ Dissecting the Financial Collapse of 2007-2008: A Two-Year Flight to Quality, May 2012, available at <http://www.sec.gov/comments/4-619/4619-188.pdf>.

not embody the best traditions of government. It is therefore incumbent upon all of us, regulators, industry and Congress, to bring perspective and rationality to the debate. It is our obligation to weigh the enormous benefits of MMFs against a realistic assessment of the speculative benefits, and evidence of significant adverse economic consequences, that the various “reform” proposals would bring. We strongly endorse Congressional efforts to clarify the SEC’s statutory obligation to perform cost/benefit analysis and to commission a thorough evaluation of the need for additional reform to money market funds. Such a study should not only include an evaluation of the impact of the 2010 reforms to MMF regulations, but also should factor in the reforms adopted in the Dodd-Frank Act. Americans deserve a regulatory process that can hear their voice: they would prefer to keep the massive efficiency gains with the current system and accept the risk of a very high quality, tightly regulated investment product, rather than turn back the clock and return to a world even more dominated by the largest banks.

1. Setting the Record Straight on Money Market Funds

Before addressing these threatened reforms, I would like to dispel some myths regarding MMFs that purport to justify the need for further reforms.

Myth: *The \$1 share price of MMFs is a “fiction” or “gimmick.”*

Fact: *The stable \$1 price is real—MMFs have redeemed their shares for at a stable \$1 price for over forty-years, with only two exceptions.*

Every day, for over 38 years, Federated’s MMFs have redeemed shares at a stable \$1 value. This is true of every other MMF currently in existence. During the past forty-plus years, only two MMFs have redeemed shares for less than a \$1, known as “breaking a dollar.”

This record of stability is the result of the high quality and short-duration of MMF portfolios, not accounting wizardry. Regulations require MMF portfolios to consist of a diversified cross-section of the highest quality debt instruments available in the market. The market values of these instruments rarely deviate significantly from their amortized

cost. Federated regularly monitors the estimated market value of its MMFs (known as their “shadow prices”), which typically do not deviate by even a tenth of a cent from \$1 (*i.e.*, 10 basis points). An Investment Company Institute (“ICI”) sampling of the shadow prices of other MMFs shows that this is common throughout the industry.⁴

Such small shadow price deviations do not affect a MMF’s ability to operate at a stable value because portfolio instruments quickly return to their amortized cost. MMFs typically maintain an average maturity of between 30 and 50 days. This makes it easy for MMFs to wait for investments to mature, rather than selling them at a gain or loss.

MMFs also avoid gains and losses by maintaining more than enough liquidity to meet anticipated shareholder redemptions. This “best practice” was codified in the regulatory reforms adopted in 2010. The MMFs’ record for managing liquidity is exemplary—no fund has ever broken a dollar because a fund failed to maintain sufficient liquidity to meet redemptions. The capacity of some MMFs to maintain daily liquidity was tested again in the summer of 2011, and every fund answered the challenge without any disruption to the market.

On a related point, critics sometimes assert that the \$1 share price misleads investors into believing that MMFs are like banks. These critics overlook the fact that most of the money held in MMFs comes from sophisticated institutional investors, who surely appreciate the differences between MMFs and banks. Recent surveys show that most retail investors also appreciate that their MMF can break a dollar and that no one has promised to protect them from any losses.⁵ These critics further ignore the bold face disclaimer on the front of every Federated MMF prospectus and advertisement: “**Not FDIC Insured •**

⁴ Pricing of U.S. Money Market Funds at 4, ICI Research Report (Jan. 2011), available at http://www.ici.org/pdf/ppr_11_mmf_pricing.pdf.

⁵ The Investor’s Perspective: What Individual Investors Know about the Risks of Money Market Mutual Funds, FMR LLC (Apr. 2012), available at <http://www.sec.gov/comments/4-619/4619-170.pdf>.

May Lose Value • No Bank Guarantee.” Thus, MMFs fully disclose the risk that they may break a dollar and the overwhelming majority of MMF shareholders understand and accept this risk.

Myth: *MMFs have only been able to maintain a \$1 share price due to the support provided by their managers.*

Fact: *Over 90% of MMFs have maintained a \$1 share price without any support from their managers.*

At the beginning of 2007, there were 728 MMFs. The Federal Reserve has recently asserted that, from 2007 to 2010, approximately 50 MMFs received support from their manager.⁶ This means that over 90% of MMFs maintained a \$1 share price throughout the recent financial crisis without any support from their managers. All of Federated’s MMFs maintained a \$1 share price without any support from Federated during the period. Historically, managers have provided support to their funds in part because they typically do not incur any losses as a result of the support. This explains why managers commonly find it in their interest to protect their MMFs’ shareholders at no material cost to themselves. Although no manager promises to provide support for its funds, mutually beneficial support arrangements should be appreciated as an indication of the resilience of MMFs rather than as a weakness.

Myth: *MMFs are susceptible to runs.*

Fact: *In over forty years, there has been only one run on prime MMFs and it was a consequence of a general flight to safety at the height of the financial crisis.*

As I noted, there have been two instances of a MMF breaking a dollar. The first, in 1994, did not produce a run on MMFs. In fact, it went largely unnoticed. The second, the Reserve Fund, coincided with the redemption of approximately 15% of the assets held by prime MMFs during the week of September 15, 2008.

⁶ Presentation by Federal Reserve Bank of Boston President Rosengren (Apr. 11, 2012), available at http://www.frbatlanta.org/documents/news/conferences/12fmc/12fmc_rosengren_pres.pdf.

So far as I know, the SEC has not attempted to study why breaking a dollar in 1994 had no impact on other funds, while prime MMFs experienced substantial redemptions at the time the Reserve Fund broke a dollar. The SEC appears to assume that, because the run on MMFs coincided with the Reserve Fund breaking a dollar, the Reserve Fund caused the run. A comparison of the market conditions in 1994 and 2008 refutes this assumption.

In 1994, the Community Bankers MMF broke a dollar because it held derivative securities that the SEC found “were too risky and volatile for a money market fund.”⁷ The credit market was operating normally, so there were no concerns about the availability of liquidity. The market therefore viewed Community Bankers as an isolated incident, with no implications for other MMFs or for the market in general. Shareholders did not run from other MMFs because they had no reason to suspect that another MMF would break a dollar.

In contrast, 2008 was marked by a complete loss of confidence in the financial system. The run on MMFs coincided with the rescue of AIG, the arranged merger of Merrill Lynch with Bank of America and many other financial shocks. Many investors were uncertain as to whether other financial institutions would fail and whether they would receive government support. Rather than risk a default, these investors sought to shift their cash to government securities, draining liquidity from the credit market. The credit market was completely frozen before the Reserve Fund tried to liquidate its portfolio.

Other MMFs were not immune to this market turmoil. Their shareholders also fled to government securities, as evidenced by the fact that nearly two-thirds of the assets redeemed from prime MMFs were added to government MMFs. This also shows that redemptions were motivated by concerns regarding the credit market generally and not MMFs themselves. This suggests that the shareholders would have redeemed regardless of

⁷ In the Matter of Craig S. Vanucci and Brian K. Andrew, Investment Company Act Release No. 23638 (Jan. 11, 1999), available at <http://www.sec.gov/litigation/admin/33-7625.txt>.

whether the Reserve Fund broke a dollar, in order to eliminate credit risk by shifting their cash to government securities.

Thus, the record over the past forty years includes one fund that broke a dollar without causing a run, and one run that coincided with a MMF fund breaking a dollar but was largely caused by a flight to safety in response to an unprecedented financial crisis. That certainly does not qualify MMFs as “susceptible” to runs. There is no reason to project that an event in the future that causes one or more MMFs to break a dollar would prompt shareholders to redeem from other MMFs not affected or threatened by the event. Indeed, in light of the significant enhancements in transparency and liquidity of MMFs following the 2010 reforms, MMF investors should be even less likely to run.

Myth: *Taxpayers rescued MMFs in 2008.*

Fact: *We did not ask for or need the Treasury’s Temporary Guarantee Program (the “Treasury Program”) and no claims were made under the program.*

MMFs required liquid markets, not tax dollars, to weather the financial crisis in 2008. Their portfolios were sound, but the global liquidity crisis impacted MMFs just as it did virtually all other asset classes.

Due the lack of market liquidity, we requested liquidity, rather than Federal insurance, for our MMFs in response to the financial crisis. During our discussions, the Treasury told us that the Treasury Program was going to be announced; we never asked for it. We did not think that the Treasury Program addressed the real problem—the need to reassure shareholders that MMFs had enough liquidity to continue to redeem their shares for \$1.

In my view, the Federal Reserve’s Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility (AMLF),⁸ rather than the Treasury Program, restored confidence in MMFs. AMLF provided funding to banks and other institutions to buy asset-

⁸ Information on AMLF can be found at http://www.federalreserve.gov/newsevents/reform_amlf.htm. Another liquidity facility, the Money Market Investor Funding Facility was established but never utilized.

backed commercial paper from MMFs. AMLF ultimately funded sales of approximately \$220 billion, a small fraction of the massive liquidity the Federal Reserve pumped into virtually every corner of the financial markets during the crisis.

AMLF was announced on the same day as the Treasury Program—September 19, 2008. By the second week of October, prime MMF assets had stabilized. Although some would attribute this to the combination of AMLF and the Treasury Program, it is noteworthy that prime fund assets grew continuously throughout the rest of 2008, even though the Treasury Program only covered balances held on September 19th, so these additional assets were not guaranteed. Moreover, the Treasury Program was limited to \$50 billion, which was just over 1% of the September 19th MMF assets. Thus, within four weeks of the onset of the financial crisis, investors were confident enough to invest in prime MMFs without reliance on a Federal guarantee.

Regardless of the reasons, it cannot be disputed that confidence in prime MMFs was fully restored without any Federal expenditures. In fact, the Treasury kept all \$1.2 billion of premiums paid under the Treasury Program without paying any claims. All of the paper sold under AMLF was repaid in full, with interest, when due.

The recovery of prime MMFs with a relatively minor liquidity program is a testament to the inherent resiliency of MMFs. If banks and other financial institutions had responded as well to their support measures, which included trillions in additional Federal deposit insurance, multiple liquidity programs and the investment of hundreds of billions under TARP, the financial crisis would have been resolved before the end of 2008. MMFs were the last institutions to require a liquidity program and the first to recover—a mark of resiliency and not of “fragility.”

2. The 2010 Reforms Addressed the Need for Liquidity during a Financial Crisis

MMFs were not only the first to recover from the financial crisis; they also were the first to adopt reforms to prevent a recurrence of problems encountered during the crisis. In March 2009, the ICI provided the SEC with proposed regulatory reforms. Using the ICI's

report as a starting point, the SEC proposed reforms in June of 2009 and adopted final rules in February 2010. Most of the reforms were implemented by May 2010 and the balance by the end of that year. No other industry responded as promptly or adopted such far-reaching reforms as MMFs.

Four of the reforms targeted liquidity. First, the SEC adopted a new rule, 22e-3, permitting a MMF's board of directors to suspend redemptions while liquidating a fund. This gives directors two options if a MMF breaks a dollar. If there is adequate market liquidity, the fund can operate with a fluctuating NAV and sell its portfolio to pay for redemptions. If markets are frozen or it would otherwise serve the shareholders' interest, the directors can suspend redemptions and distribute payments from the portfolio as it matures. As I mentioned, MMFs historically maintain average maturities of 30 to 50 days, so shareholders would receive most of their money back within this period. The maximum permitted maturity is 397 days, so the liquidation would not take much longer than a year to complete.

Rule 22e-3 gives directors the power to prevent a run from a MMF that has broken or threatens to break a dollar. It also prevents a fire sale of the portfolio into an illiquid market. The result is that every MMF, not just the largest, already has the type of orderly resolution plan contemplated by Title II of the Dodd-Frank Act, except that the plan does not require a Federal receiver or Federal insurance.

The second reform was to increase transparency. Every MMF must post its entire portfolio on its website as of the end of each month. This allows the public and regulators to identify which MMFs are affected by a credit or other adverse event. Although affected MMFs may need to address the event, shareholders in unaffected funds will not face the same uncertainty as investors in banks and other less transparent institutions. They should not have any reason to redeem from MMFs that they know to be sound and unimpaired by the event.

The third reform codified an industry practice of knowing your customers and monitoring their share activity. This requires that a MMF manager monitor and prepare for the risk of large shareholder redemptions, taking into account current market conditions. This is designed to assure that MMFs remain prepared to meet their shareholders' liquidity needs.

The final reform deals with the possibility that some shareholders may nevertheless redeem from MMFs on the occurrence of certain market events, regardless of their actual risks. The reform established liquidity floors: minimum amounts of liquidity that each MMF must be able to generate on a daily and weekly basis without selling anything other than Treasury and other government securities. The floors are 10% for daily liquidity and 30% for weekly liquidity. Remember that 15% of prime fund assets were redeemed during the week of September 15, 2008, so the weekly liquidity floor is twice the level of redemptions experienced during that period. In these still uncertain times, prime MMFs are maintaining an average weekly liquidity of 43%, nearly three times the level of the 2008 redemptions.⁹

These reforms were tested during the summer of 2011. In response to concerns about European banks and whether Congress would raise the U.S. debt ceiling, shareholders redeemed over 10% of prime MMF assets during the period from June 8 through August 3, 2011.¹⁰ As you would expect, redemptions were higher in some prime MMFs than in others. None of the MMFs had trouble meeting these redemption requests and there was no impact on the overall market. Throughout the period, average weekly liquidity in prime MMFs remained at 40% or more, so the funds covered these redemptions

⁹ ICI summary of data from Form N-MFPs as of April 30, 2012.

¹⁰ ICI Summary: Money Market Funds Asset Data, available at http://www.ici.org/info/mm_summary_data_2012.xls.

without tapping into their liquidity cushion. The new reforms clearly passed this real-life stress test.

Certain members of FSOC and the Chairman of the SEC contend that more must be done to prevent a recurrence of the redemptions experienced in September 2008. Apart from ignoring the fact that prime MMFs are already prepared to handle significantly larger redemptions, their contention also ignores how the redemptions resulted from a general financial panic. No reform of MMFs can prevent shareholders from seeking a safe haven during such a complete loss of investor confidence. Efforts to eliminate all risks from MMFs will not prevent a future crisis; they will only eliminate MMFs.

3. Reforms Currently under Consideration Are Fundamentally at Odds with the Nature of Money Market Funds and the Needs of their Shareholders

Investors use MMFs to obtain stability and daily liquidity with a market rate of return. Each of the reforms that the SEC Chairman has recommended: a floating NAV, redemption restrictions and capital, would eliminate one of these essential elements. The consequences of these reforms would therefore be, from an investor's perspective, the elimination of MMFs as a viable alternative for cash investment. This is confirmed by surveys and other data, which suggest that the threatened reforms would drive upwards of three-quarters of their assets from MMFs.

(a) MMF NAVs Should Only Float When Necessary to Protect Shareholders

MMFs already have floating NAVs, as demonstrated by the fact that funds have broken a dollar. The question is how often the NAV should float. Under current regulations, directors must float the NAV when necessary to protect shareholders from excessive dilution or other unfair results. Dilution is presumed to be excessive when the shadow price deviates from \$1 by more than half a cent, although directors retain some latitude for judgment even in this circumstance.

The threatened reform would require the NAV to float regardless of the shareholders' interest. Studies of historical shadow prices show that share prices would fluctuate infrequently, with periods of several years between price fluctuations. Moreover, the price changes would typically not amount to more than one or occasionally two tenths of a percent and would not last for longer than several weeks. The potential fluctuations would require shareholders to monitor, calculate and record infinitesimal and ephemeral gains and losses on cash investments for accounting and tax purposes. From a shareholder's perspective, dealing with these potential price fluctuations would result in enormous costs.

Surveys show that investors would rather move their money elsewhere rather than deal with such pointless fluctuations.¹¹ Many fiduciaries will not have a choice, as statutes or trust instruments may require investment of cash in stable value investments. Therefore, eliminating the stable value that, under normal circumstances, shareholders want and MMFs deliver will eliminate MMFs as a viable alternative for most cash investors.

(b) Redemption Restrictions Could Be Worse than Floating NAVs

Shareholders object to redemption restrictions even more strongly than they do to a floating NAV. This is understandable: although a floating NAV would cause share prices to fluctuate needlessly, the fluctuations would be infrequent and temporary. Redemption restrictions, on the other hand, would continually disrupt a shareholder's access to his or her cash in order to address an event (the fund breaking a dollar) that might occur once in twenty years, if it ever occurs at all. Their reaction is similar to passengers on a cruise who have been asked to confine their activities to the lifeboats just in case the ship hits an iceberg.

¹¹ The Investor's Perspective: What Individual Investors Know about the Risks of Money Market Mutual Funds, *supra* note 5, and Money Market Fund Regulations: The Voice of the Treasurer, Apr. 2012, available at http://www.ici.org/pdf/rpt_12_tsi_voice_treasurer.pdf.

In addition to shareholders' rejection of redemption restrictions, there are no practical means of implementing them. Although the SEC has not provided any details of the redemption restrictions under consideration, as a general matter they must involve: (1) setting aside a certain percentage of shares or proceeds from the redemption of shares for a period of time and (2) charging any losses incurred by the fund during the period against the shares or proceeds set aside. Fund organizational documents and share trading systems were not designed to do these things. Therefore, implementing redemption restrictions would entail completely rewriting every fund's organization documents and getting shareholders to approve the changes, and reprogramming every trading system for fund shares. The transition costs would be staggering, as would the ongoing operational cost of tracking and restricting shares or proceeds. Many intermediaries would probably stop offering MMFs rather than bear these costs.

(c) Requiring Excess Capital Would Prevent Money Market Funds from Offering a Market Rate of Return and Introduce Moral Hazards

Even the SEC Chairman and members of the FSOC seem to have realized that forcing MMFs to raise subordinated capital from third parties or their managers would make the fund unduly complicated and impractical. I will therefore assume that the only capital proposal still under consideration would be for MMFs to build up capital over time through retaining a portion of their earnings. From a shareholder's perspective, this form of capital requirement would impose a certain loss—in the form of reduced returns—in order to reduce the risk of a speculative loss—the possibility that the fund might break a dollar.

It also would take an exceedingly long time to build up a significant capital buffer. With interest rates currently near zero, MMFs do not have any income to retain for a capital buffer. Even in normal market conditions, the yield on a prime MMF averages only 18 basis points more than the yield on a government agency MMF. Assuming for purposes of analysis that the difference is constant, which it is not, and that shareholders would continue to

use prime MMFs if this spread was cut in half, which they may not, it would take over eleven years for a prime fund to build a 1% capital buffer through retained earnings.

This analysis does not include the taxes imposed on the fund's retained income. After factoring in state taxes, close to half of any earnings reduction will go to the government rather than building a capital buffer for the shareholders. Federal corporate income taxes alone, at current rates, would increase the time required to build a 1% capital buffer to more than 17 years.

Capital buffers also could create a moral hazard by leading MMF shareholders to believe that they will not bear the risk of portfolio losses. This can only increase expectations that a MMF should be bailed out if its losses exceed the capital buffer, as Federal regulators would have represented to the public that their capital requirements were sufficient to make MMFs safe. The financial system will be better off if the hint of protection from a capital buffer does not dilute current warnings that MMFs are not guaranteed and may lose money.

Once we understand that MMFs are investments, we should realize that MMFs are already funded entirely by shareholder capital. Shareholders receive higher yields to compensate them for the risk of their MMF breaking a dollar, which has proven to be a highly profitable arrangement for MMF shareholders

4. Destruction of Money Market Funds Will Injure the Economy and Increase Systemic Risks

As I noted, the best available estimates suggest that requiring a floating NAV or redemption restrictions will drive upwards of three-quarters of the assets out of MMFs. At current asset levels, this would comprise more than \$2 trillion. It is harder to estimate the impact of capital requirements, insofar as we do not know the elasticity of demand for prime MMFs relative to their spread over government MMFs. Reduced returns will surely translate into reduced assets, however.

Where would all this money go? Very large institutional investors, those with over \$100 million in investments who could qualify for the Rule 144A safe harbor, might invest directly in the same instruments as MMFs. They would have to hire managers for these investments, who would be unlikely to have as many resources or as much experience as those who currently manage MMFs. The portfolios would not be as well diversified as MMFs. A better alternative for these institutions might be to invest in a private MMF, completely unregulated by the SEC. Thus, one consequence of the threatened reforms would be to reduce the SEC's oversight and regulation of participants in the money markets.

Other institutional investors, and nearly all retail investors, would have to move their cash to banks. This would increase systemic risks in several respects. First, bank holding companies already designated as systemic risks under the Dodd-Frank Act control over half of MMF assets.¹² This suggests that most of the money driven out of MMFs will end up in banks that are already too big from a systemic risk perspective.

Second, much of the retail and some of the institutional money will end up in insured accounts, increasing the size of the Federal safety net. Banks will also need to raise additional capital for these deposits, at a time when they are already straining to comply with the new Basil III requirements.

Third, to limit the need for additional capital, banks are unlikely to use the new funds to make commercial loans. Unlike prime MMFs, which have to put every dollar to work, banks have the option of leaving funds in their Federal Reserve accounts. Banks may also find it easier to invest in Treasury and government agency securities. To the extent that banks choose to make commercial loans, the absence of competition from MMFs will allow them to charge higher interest rates. Hence, the reduction in prime MMF assets will produce a corresponding reduction in credit to the private sector and an increase in the

¹² Crane Data.

cost of such credit. If we consider that prime MMFs hold over 40% of the outstanding commercial paper, we can appreciate the potential impact of this on the economy.

The credit impact on municipalities will be even worse. Most municipalities rely on loans from tax-exempt MMFs to bridge the period between expenditures and periodic tax collections. Before MMFs, banks provided this financing, charging municipalities the prime rate for their working capital. Assuming banks will return to this role, the additional interest charges will place a considerable drag on already over-burdened municipal budgets.

The reforms will destroy MMFs in a more fundamental sense as well. As I observed, investors look to MMFs for stability and daily liquidity with a market rate of return. A floating NAV would prevent MMFs from offering stability, redemption restrictions would prevent them from offering daily liquidity, and capital requirements would prevent them from offering a market rate of return. Therefore, all of the reforms are designed to eradicate MMFs as we now know them, rather than to “shore up” the funds as asserted by the SEC’s Chairman.

5. The SEC Should Conduct a Thorough Study of Money Market Funds, their Shareholders and the Effects of the 2010 Reforms and the Dodd-Frank Act before Proposing any Further Reforms

Previous reforms to MMF regulations involved careful examinations by the SEC staff of the performance and operations of MMFs, including on-site visits and face-to-face discussions with fund managers. In the case of the 2010 reforms, the SEC staff had the benefit of a report and recommendations from the ICI’s Money Market Fund Working Group. The Working Group was composed primarily of portfolio managers who had hands-on experience in guiding their MMFs through the 2008 financial crisis. This put them in the best position to know what tools and changes might serve to avoid or manage another crisis. The SEC gave serious consideration to the reforms proposed by the ICI Working Group. Although the reforms adopted by the SEC in 2010 went further than Federated thought was warranted, the reforms were largely consistent with the information provided in the Working Group’s report.

Such due diligence and interaction has been lacking in this “second phase” of the reform process. So far the process has consisted of a series of trial balloons floated by the regulators and shot down by the industry, representatives of MMF shareholders and organizations concerned with the efficiency of short-term credit markets. The SEC staff has not made any efforts to look beyond industry-level data and examine what happened to individual funds and shareholders during September 2008, or to establish what changes might be realistic from a performance or operational perspective.

The 2010 reforms require MMFs to file a monthly report with the SEC containing volumes of information regarding their portfolios. The SEC staff has yet to use this information to provide any public assessment of the impact of the 2010 reforms on the risks and character of MMFs. In addition, the SEC staff has not attempted to analyze whether the “know your customer” requirements of the 2010 reforms have affected fund cash flows.

As a first critical step in their cost/benefit analysis of possible reforms, the SEC staff must identify the benefits of MMFs to investors, capital formation and market efficiency, and quantify these benefits to the fullest possible extent. They must quantify how the proposed reforms would jeopardize these benefits. As numerous commenters have documented significant adverse consequences, the SEC must thoroughly evaluate the associated cost and risk to the capital markets and economy, including the substantial risk of the loss or increased cost of credit to the many borrowers who rely on MMFs for short term funding.

The SEC staff also must demonstrate and measure any purported reduction in systemic risk of a proposed reform. The SEC may not, as Commissioner Gallagher aptly put it, “simply hand-wave and speak vaguely of addressing ‘systemic risk’ or some other kind of protean problem.”¹³ I hope that the Committee agrees that any further reforms of MMF

¹³ “SEC Reform after Dodd-Frank and the Financial Crisis”, speech by Commissioner Daniel M. Gallagher before the U.S. Chamber of Commerce (Dec. 14, 2011), available at <http://www.sec.gov/news/speech/2011/spch121411dmg.htm>.

regulations should comply with the same rigorous standards for cost/benefit analysis that the SEC has represented it will apply to regulations mandated by the Dodd-Frank Act.

The ICI, Federated and other MMF managers, and other organizations have attempted to fill this information gap by sponsoring surveys and preparing studies of the financial and operational impact of various proposals. With the advent of FSOC, the SEC staff no longer appears to give this information the same consideration that they gave to the ICI Working Group report. Certainly the SEC Chairman continues to make public statements that either are contradicted by these studies or fail to acknowledge important issues raised by them.

Although I confess to being skeptical of the need for further reforms, Federated is willing to consider and assist the SEC, the ICI and the industry in assessing reform proposals that would enhance the resilience of MMFs. I am asking this Committee to encourage the SEC to do the research necessary to determine what changes, if any, are truly needed, and to express its commitment to the continued vitality and growth of this important investment product.

I look forward to answering your questions.

ATTACHMENTS AND REFERENCES

Attachments

1. Money Market Funds and Folklore: A Response to Chairman Volcker
2. The FSOC: Band of Equals or New Bully on the Block
3. Leave Money Market Funds Alone!
4. Busting through the Folklore About Money Market Funds: The Fact Is they Cost Taxpayers Nothing
5. A Regulatory Success Story: How the SEC's 2010 Rule Changes Have Increased Liquidity and Transparency at Money Market Funds
6. Excerpt from Letter from John D. Hawke, Jr., Arnold & Porter LLP, on behalf of Federated Investors, Inc., submitted to the FSOC, Dec. 15, 2011
7. Letter from John D. Hawke, Jr., Arnold & Porter LLP, on behalf of Federated Investors, Inc., submitted to the SEC, Feb. 24, 2012
8. Excerpt from Letter from John D. Hawke, Jr., Arnold & Porter LLP, on behalf of Federated Investors, Inc., submitted to the FSOC, Nov. 5, 2010
9. Statement of Federated Investors, Inc. Submitted to the Subcommittee on Capital Markets and Government Sponsored Enterprises Committee on Financial Services United States House of Representative, June 24, 2010

Federated Comment Letters on Money Market Fund Proposals

John W. McGonigle, Vice Chairman, Federated Investors, Inc., Jan. 7, 2011, available at <http://www.sec.gov/comments/4-619/4619-15.pdf>. [Comments on the PWG Report.]

John D. Hawke, Jr., on behalf of Federated Investors, Feb. 24, 2011, available at <http://www.sec.gov/comments/4-619/4619-82.pdf>. [Response to the Squam Lake Group comments on the PWG Report.]

John D. Hawke, Jr., Arnold & Porter LLP, on behalf of Federated Investors, Inc., Mar. 15, 2011, available at <http://www.sec.gov/comments/4-619/4619-89.pdf>. [Response to Mr. Paul Volcker comments on the PWG Report.]

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