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C.F.T.C.

COMMENT

November 30, 2010

Mr. David A. Stawick
Secretary of the Commission
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20581

Re: RIN 3038-AC15—Proposed Rulemaking Regarding Investment of Customer Funds under Regulation 1.25 (the "Proposed Rulemaking")

Dear Mr. Stawick:

This letter presents the comments of Federated Investors, Inc. and its subsidiaries ("Federated") on the Commission's Proposed Rulemaking. Federated and its subsidiaries manage approximately 90 money market funds with over $330 billion in assets under management. Federated's money market funds are widely used as investments for customer segregated accounts by futures commission merchants ("FCMs"). Our comments are limited to the Commission's specific requests for comments concerning money market funds ("MMFs").

**General Comments**

We support the Commission's goal to increase the safety of investments under Regulation 1.25 by promoting diversification and agree that this goal can be furthered by issuer-specific concentration limits. However, we believe that the Commission should consider different concentration limits than the ones proposed for MMFs, as discussed below.

We agree with the Commission that "the safety of a particular instrument or transaction must be viewed through the lens of its likely performance during a period of market volatility and financial instability."[1] MMFs performed well during the financial crisis in 2008 and indeed demonstrated greater stability overall than alternative instruments except U.S. government securities.

We believe that the Commission should give great weight to regulations governing specific instruments in assessing their safety. In this regard, we discuss recent regulatory changes under the SEC's Rule 2a-7 that enhance the safety of MMFs as investments under

[1] 75 Fed. Reg. 67642, 67644 (Nov. 3, 2010) (the "Proposed Rule").

Regulation 1.25. None of the alternative investments are regulated as comprehensively as MMFs to ensure liquidity and ability to preserve principal.

**MMFs are Safe, Liquid Investments for Customer Segregated Accounts**

Federated agrees with the Commission's decision to retain MMFs as permissible investments for customer segregated accounts of FCMs. MMFs are high-quality, broadly diversified short-term investment vehicles that invest in high-quality instruments such as commercial paper, corporate bonds, bank CDs, Treasury bills, and repurchase agreements and seek to maintain a stable net asset value of $1.00 per share.

MMFs currently have over $2.8 trillion dollars in assets under management, comprising approximately 25 percent of the total assets in registered investment companies in the United States. They are highly regulated under the Investment Company Act of 1940 and have a long history of safety and liquidity. In the 40 year history of MMFs, only two funds ever failed to return $1.00 per share to investors, and those funds returned more than 99 cents and 96 cents on the dollar.

MMFs are permissible investments for banks, municipalities, and corporate treasurers. They are used by bank trust departments, pension funds, charitable foundations, and other fiduciaries as investments for fiduciary accounts. They are considered safer than bank deposits (for amounts in excess of the $250,000 FDIC limit) and single-issuer municipal securities, commercial paper, or corporate bonds.

**MMFs Preserve Principal and Maintain Liquidity**

MMF investments satisfy the overall objectives of preserving principal and maintaining liquidity as stated in the proposed rulemaking. These objectives are a key focus of the requirements of Rule 2a-7 under the Investment Company Act of 1940, which subjects MMFs to stringent portfolio liquidity, credit quality, maturity, diversification, and other requirements.[2]

The SEC amended Rule 2a-7 earlier this year to include a number of enhancements to ensure that money market funds will be able to sustain heavy redemption requests during a severe financial crisis such as occurred in 2008. The reforms enhance even further the ability of MMFs to preserve principal and liquidity. Rule 2a-7 includes the following new requirements:

[2] The Investment Company Act governs virtually every aspect of a MMF's structure and operation, including its capital structure, investment activities, share valuation, board composition, and the duties and independence of its directors. MMFs also are subject to extensive recordkeeping requirements and regular inspections. Further, the advisers to MMFs are subject to SEC registration under the Investment Advisers Act of 1940, which imposes a fiduciary duty on them and imposes its own reporting and recordkeeping requirements, prescribes the terms of advisory contracts, and provides for SEC inspections and examinations. MMFs must register offerings of their securities with the SEC and provide perpetually updated prospectuses to potential investors. They must also file periodic reports with the SEC and provide shareholders with annual and semi-annual reports, which must include financial data and a list of portfolio securities.

**Enhanced Credit Quality**. Under Rule 2a-7, as amended, 97 percent of a MMF's assets must be invested in "First Tier Securities."[3] Only three percent of its assets may be held in lower quality "Second Tier Securities."[4] In addition, a MMF may invest only one-half of one percent of its assets in "Second Tier Securities" issued by any one issuer.[5] Also, a MMF is prohibited from purchasing "Second Tier Securities" that mature in more than 45 days.[6]

**Shortened Maturity Limits**. The "weighted average maturity" of a MMF's portfolio is restricted to 60 days (compared to the previous limit of 90 days). In addition, a 120 day maximum "weighted average life" maturity applies to MMF portfolios, limiting a MMF's ability to invest in long-term floating rate securities and providing an extra layer of protection for MMFs and their shareholders against spread risk, particularly in volatile markets. These changes make MMFs more resilient to changes in interest rates and related market shocks.

**Diversification and Liquidity**. MMFs must limit their investments in the securities of any one issuer (other than U.S. government securities) to no more than five percent of fund assets and, as noted, a MMF may not invest more than one-half of one percent of its assets in "Second Tier Securities" issued by any one issuer. Prior to the 2010 amendments, Rule 2a-7 did not impose any minimum liquidity requirements. Rule 2a-7 now requires all taxable MMFs to have at least 10 percent of their assets in cash, U.S. Treasury securities, or securities that convert into cash (*e.g.*, mature) within one business day. All MMFs must have at least 30 percent of their assets in cash, U.S. Treasury securities, certain other government securities with remaining maturities of 60 days or less, or securities that convert into cash within five business days.

In addition, MMFs are required to hold securities that are sufficiently liquid to meet reasonably foreseeable shareholder redemptions. Rule 2a-7 also requires MMFs to adopt policies and procedures to identify the risk characteristics of large shareholders and anticipate the likelihood of large redemptions. The SEC designed these diversification and liquidity requirements so that, even in market conditions such as those in 2008, MMFs will have sufficient cash to satisfy anticipated redemptions without reliance on a secondary or dealer market to provide immediate liquidity.

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[3] A "First Tier Security" means any Eligible Security that: (i) is a Rated Security (as defined in Rule 2a-7) that has received a short-term rating from the requisite NRSROs in the highest short-term rating category for debt obligations (within which there may be sub-categories or gradations indicating relative standing); (ii) is an unrated security that is of comparable quality to a security meeting the requirements for a rated security in (i) above, as determined by the fund's board of directors; (iii) is a security issued by a registered investment company that is a MMF; or (iv) is a Government Security. The term "requisite NRSROs" is defined in Rule 2a-7(a)(23) to mean "(i) Any two Designated NRSROs that have issued a rating with respect to a security or class of debt obligations of an issuer; or (ii) If only one Designated NRSRO has issued a rating with respect to such security or class of debt obligations of an issuer at the time the fund acquires the security, that Designated NRSRO."

[4] Second Tier Securities are any Eligible Securities that are not First Tier Securities. Previously, a MMF was permitted to invest 5 percent of its assets in "Second Tier Securities."

[5] Previously, the limit was the greater of one percent or $1 million.

[6] The previous limit was 397 days.

**Periodic Stress Tests**. Prior to the 2010 amendments, MMFs were not subject to stress test requirements. Now, Rule 2a-7 requires the board of directors of each MMF to adopt procedures providing for periodic stress testing of the funds' portfolio. In addition, they must exam the fund's ability to maintain a stable NAV per share based upon certain hypothetical events including, among other things, a change in short-term interest rates, higher redemptions, a downgrade of or default on portfolio securities, and widening or narrowing of spreads between yields.

**Disclosure of Portfolio Information**. Previously, a MMF's "shadow" NAV was reported to the SEC twice a year with a lag of 60 days. Amended Rule 2a-7 now requires MMFs to post their portfolio holdings each month on their web sites. MMFs also must file monthly reports of portfolio holdings with the SEC, which must include the market-based values of each portfolio security and the fund's "shadow" NAV. The information becomes publicly available after 60 days. This requirement gives investors a better understanding of the current risks to which the MMF is exposed and strengthens the investors' ability to exert influence on risk-taking by fund advisers.

**MMFs Are Safer and More Liquid than CDs or Municipal Securities**

Given the 40-year history of MMFs providing a market rate of interest with stability of principal, we are at a loss to understand the Commission's proposal that would allow higher concentration limits for CDs and municipal securities, which are less safe investments. MMFs are highly diversified and more liquid than either bank CDs or municipal securities.

Bank CDs are insured by the FDIC only up to $250,000, far below the amounts typically invested by FCMs.[7] As the Commission noted in its Proposed Rulemaking, "CDs are safe for relatively small amounts, but the risk increases for larger sums."[8] According to FDIC data, during the past 40 years, some 2,807 depository institutions have failed and an additional 592 have been the subject of government assistance transactions.[9] During this time, total estimated FDIC losses incurred in connection with failed banks or assistance transactions totaled $165 billion. In the recent financial crisis, nearly 300 banks failed and even more would have done so absent government assistance. The FDIC recently reported that the number of insured institutions on its "Problem List" rose from 829 to 860.[10]

In comparison, only one MMF—the Reserve Primary Fund—failed to redeem investors' shares at less than par during the recent crisis and investors in that fund ultimately received more than 99 cents on the dollar.[11] Although the Treasury Department implemented a temporary

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[7] Pursuant to the Dodd-Frank Act, the FDIC will provide unlimited insurance on non-interest bearing business checking accounts, but only until Dec. 31, 2012.

[8] Proposed Rulemaking, 75 Fed. Reg. at 67648.

[9] These figures do not include failures in 2010. FDIC Database of Failures and Assistance Transactions (http://www2.fdic.gov/hsob/SelectRpt.asp?EntryTyp=30).

[10] Federal Deposit Insurance Corporation, Press Release dated Nov. 23, 2010.

[11] Only one other MMF ever has broken a dollar and, as noted, returned 96 cents on the dollar.

guarantee program for money market funds during the crisis, no payouts or losses occurred. No MMFs were "bailed out."

MMFs also are safer than municipal securities, which the Commission has recognized as "increasingly volatile and, in some cases, increasingly illiquid."[12] These instruments are susceptible to significant credit risk as obligations of cities and towns that can seek Chapter 9 bankruptcy protection from debts. Currently many municipalities are in weakened financial condition due to failing tax revenues, rising costs, and states withholding revenue. Analysts have estimated that a total of $5 billion of municipal bonds were in default as of the end of the first quarter of 2010—approximately three times the normal rate, and other municipal issuers have reportedly missed payments.[13]

**Financial Service Reform Legislation and MMFs in a Post-Rule 2a-7 Environment; How They Refute Proposals by the Commission to Limit Instrument-Based Concentration of MMFs to 10% of an FCM's Total Assets and Issuer Concentration of an FCM's Total Assets to Two Percent in Any One Family of Funds**

It is our view that the proposals relating to money market funds and instrument-based and issuer-based concentration are unwarranted in a post- Dodd-Frank Act and amended Rule 2a-7 era. As discussed in detail in prior pages, the "breaking of the buck" by the Reserve Primary Fund in 2008 precipitated a full-scale review of the money market fund regulatory regime by the SEC. In announcing revisions to Rule 2a-7, the SEC asserted that the new rules "will help reduce risks associated with money market funds so that investor assets are better protected and money market funds can better withstand market crises. . . . The rules will tighten the maturity and credit standards for money market funds **and impose new liquidity requirements**. In addition, the new rules will create a substantial new disclosure regime so that everyone from the investors to the SEC itself can better monitor a money market fund's investments and risk characteristics. . . . In addition, these rules will take important initial steps towards making money market funds **less vulnerable to 'runs'** and seek to limit a contagion effect of any run that may occur."

It would appear to us that the outcome sought by the SEC in adopting these post-Reserve Primary Fund modifications to Rule 2a-7 is completely consistent with the outcome sought by the Commission's rulemaking, which is to ensure that eligible investments facilitate the preservation of principal and the maintenance of liquidity.

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[12] Proposed Rulemaking, 75 Fed. Reg. at 67648.

[13] Municipalities in at least six U.S. states have enrolled in state distressed cities programs as an alternative to bankruptcy, allowing them to access emergency lines of credit while restructuring finances. Additionally, a number of municipalities have reportedly considered seeking bankruptcy protection. Overall, an estimated $886 million of general obligation municipal bonds experienced credit impairments in the first eight months of 2010 alone. This level of increased municipal defaults in 2010 comes on the heels of roughly $15 billion in municipal borrower defaults during 2008 and 2009. *See* Investing in Municipal Bonds: Safe or Sorry?, Seeking Alpha, Feb. 11, 2010; Payback Time—States' Debt Woes Grow Too Big to Camouflage, New York Times, March 29, 2010; Municipal Bond Defaults Continue at Triple the Typical Rate, Bloomberg, July 16, 2010; Cities in Debt Turn to States, Adding Strain, New York Times, Oct. 4, 2010; Municipal Bonds: The Next Financial Land Mine?, Time, May 24, 2010.

We also note that the Commission's action in proposing amendments to Regulation 1.25 has been prompted by Section 939(a) of the Dodd-Frank Act, which "obligates federal agencies to complete a review of their respective regulations for the use of assessments of the creditworthiness of securities or money market instruments within one year." The Dodd-Frank Act also implements important changes to the U.S. regulatory financial framework to address key problem areas identified by Congress that led to the destabilization of the capital markets in the fall of 2008. Simply put, if there had been no Lehman Brothers bankruptcy, the Reserve Primary Fund would not have "broken a buck." In other words, problems that existed elsewhere had a destabilizing effect not only on the institution itself but also in other areas of the short-term capital markets.

Among the problems identified by Congress and addressed in the Dodd-Frank Act are (i) inadequate regulation of risk-taking by financial institutions (e.g., Lehman Brothers); (ii) inadequate protection of consumers; and (iii) credit rating agencies' failure to provide accurate, timely credit ratings to investors (Lehman again). The creation of the Financial Stability Oversight Council (the "Council"), comprised of the federal financial regulators, is intended by Congress to serve as a forum for monitoring systemic risk and making recommendations to regulatory agencies. The Council is charged with identifying those institutions that could pose a threat to U.S. financial stability. The Council will make recommendations to the Federal Reserve Board for increasingly strict rules for capital, leverage and other requirements for "large, interconnected" bank holding companies and nonbank financial companies supervised by the Federal Reserve.

In summary, the 2,323 page Dodd-Frank Act represents the collective effort of Congress and the executive branch to prevent a repetition of the activities largely confined to the financial services sector that precipitated the domino effect of the failure of a large systemically risky company, such as Lehman Brothers, that led to the events at the Reserve Primary Fund. If one believes their efforts were successful, the proposed limitations on MMFs are unduly restrictive and unwarranted.

**Federated Proposal**

It is our opinion that there should be no concentration limitation placed on FCMs' use of MMFs, and issuer-based concentration with respect to MMFs should be twenty percent (20%) per fund family with a ten percent (10%) limit per individual fund within a fund family. This is in keeping with the fact that each MMF within a fund complex is a discrete legal entity separately registered with the SEC under the Investment Company Act of 1940 and managed in a fashion consistent with investment objectives and policies that are described in detail in a MMF's statutory prospectus.

Unlike banks and bank holding companies, a money fund complex does not constitute a series of "interconnected financial companies" that would warrant the type of issuer limits proposed by the Commission.

As we have sought the views of FCMs that utilize MMFs sponsored by our firm with respect to the proposed changes, it is apparent that there are a variety of levels of sophistication applied to the due diligence process in selecting a MMF. Some few FCMs – to the detriment of themselves and their customers – appear to have relied almost exclusively on a fund's rating (e.g., Reserve Primary Fund).

It is not uncommon in the world of corporate and institutional investing for the investor to have written policies and procedures that are applied on a consistent basis when selecting and monitoring liquidity vehicles. While there is some variation, there is general consistency in how this is done. We would strongly urge the Commission to incorporate into its final rulemaking minimum due diligence standards that an FCM must employ when selecting an investment option under Rule 1.25 to include that the investment policies be in writing and emphasize

1. Safety of principal and liquidity;
2. Investment diversification, yield, maturity and the required quality of eligible investments;
3. Methods to monitor investments (the amendments to Rule 2a-7 should facilitate this requirement);
4. Liquidity; and
5. Regulatory oversight.

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Federated Investors, Inc. thanks you for this opportunity to comment on the Commission's Proposed Rulemaking.

Sincerely,

Eugene F. Maloney
Executive Vice President and
Corporate Counsel