STATEMENT OF FEDERATED INVESTORS, INC.

SUBMITTED TO THE

SUBCOMMITTEE ON CAPITAL MARKETS AND GOVERNMENT SPONSORED ENTERPRISES COMMITTEE ON FINANCIAL SERVICES UNITED STATES HOUSE OF REPRESENTATIVES

ON

"OVERSIGHT OF THE MUTUAL FUND INDUSTRY: ENSURING MARKET STABILITY AND INVESTOR CONFIDENCE"

June 24, 2010

Introduction

We appreciate the opportunity to submit this statement for the Subcommittee's hearing to explore the issues facing mutual funds and their investors. Federated Investors, Inc. ("Federated") supports the remarks of Paul Stevens, Chief Executive Officer of the Investment Company Institute ("ICI"), and the ICI's Statement. We make this Statement to reiterate our opposition to proposals to eliminate money market funds by requiring them either to convert to a floating Net Asset Value ("NAV") or to otherwise make fundamental structural changes.

Federated has more than thirty-five years of experience in managing money market funds through many business cycles and ups and downs in the market. None of our money market funds has ever "broken the buck" (*i.e.*, failed to maintain a stable $1 value). With 134 funds and a variety of separately managed account options, Federated provides comprehensive investment management to a broad range of investors.

Federated is currently the third largest manager of money market funds in the United States. Federated pioneered the money market fund by obtaining the

very first exemptive order from the Securities and Exchange Commission in 1979 enabling the valuation of portfolio securities at amortized cost. These amortized cost exemptive orders ultimately led to the SEC's promulgation of Rule 2a-7 under the Investment Company Act of 1940.

Most people would agree that "As a general matter, money market funds have been a safe and sound investment for institutional and individual investors for more than twenty-five (25) years" (Comments of the Coalition of Mutual Fund Investors (Sept. 10, 2009))[1] and "that MMFs historically have been a paragon of stability" (Comments of Fund Democracy and the Consumer Federation of America (Sept. 8, 2009)).[2] This is largely a result of prudent regulation: the successful product of decades of cautious oversight by SEC over the development of a safe and reliable means for investors to obtain market rates of return on their cash investments, through the application of very conservative rules for money market fund's structure, operations and assets. This stewardship produced the first major regulatory changes to emerge after the crisis in 2008, when the SEC (with the support of the industry) amended money market fund regulations at the beginning of 2010 to further enhance liquidity and credit quality of money market funds. As a result of these regulations, money market funds, which currently hold $2.75 trillion in assets, represent one of the largest sources of short-term funding for our financial markets and, in Federated's estimation, have provided at least $500 billion of additional income to investors during the past twenty-five years.

In responding to the President's Working Group on Financial Markets' study of possible changes to money market funds in response to the crisis (the "PWG

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[1] Available at http://www.sec.gov/comments/s7-11-09/s71109-135.pdf.

[2] Available at http://www.sec.gov/comments/s7-11-09/s71109-79.pdf.

Report"),[3] which included proposals to eliminate money market funds by requiring them either to convert to a floating NAV or to convert into banks, Federated made detailed and fully substantiated arguments regarding the tremendous benefits that money market funds bring to the U.S. economy and the catastrophic consequences of their elimination. Federated has also submitted comments to the banking regulators in connection with rulemaking proposals to implement Titles I and II of the Dodd Frank Act. These comment letters are referenced for the record and are as follows:

- John W. McGonigle, Vice Chairman, Federated Investors, Inc., Jan. 7, 2011, available at http://www.sec.gov/comments/4-619/4619-15.pdf ("1/7/2011 Comment Letter");
- John D. Hawke, Jr., on behalf of Federated Investors, Feb. 24, 2011, available at http://www.sec.gov/comments/4-619/4619-82.pdf ("2/24/2011 Comment Letter");
- 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 ("3/15/2011 Comment Letter");
- John W. McGonigle, Vice Chairman, Federated Investors, Inc., Mar. 25, 2011, available at http://www.sec.gov/comments/4-619/4619-83.pdf ("3/25/2011 Comment Letter");
- John W. McGonigle, Vice Chairman, Federated Investors, Inc., May 19, 2011, available at http://www.sec.gov/comments/4-619/4619-101.pdf ("5/19/2011 Comment Letter"); and
- John D. Hawke, Jr., Arnold & Porter LLP, on behalf of Federated Investors, Inc., submitted to Federal Reserve Board and FDIC, June 10, 2011, available at http://www.federalreserve.gov/SECRS/2011/June/20110621/R-1414/R-1414_061011_81322_587072501071_1.pdf ("6/10/2011 Comment Letter").

We believe requiring a floating NAV or capital requirements will either directly or effectively kill the money market fund as a cash management vehicle. The record is extensive and clear that many cash investors do not want and will not use a floating NAV fund for cash investments. At a time when money market funds are

[3] 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.

offering annual yields of two basis points, the ability to invest on a "dollar-in/dollar-out" basis is the only plausible explanation for why money market funds continue to attract nearly $2.75 trillion in assets. Much of this money would leave the funds if they were forced to convert to a floating NAV. (1/7/2011 Comment Letter at 6.) Capital requirements, on the other hand, would have the same effect by completely eliminating any yield advantage to investing in a prime fund, which would result in investors moving en masse to government money market funds.

The following will, first, summarize the core arguments in favor of the continuation of money market funds, and second, address proposals that would change the structure of a money market fund to add a capital requirement.

Arguments in Favor of the Continuation of Money Market Funds

Money Market Funds Are a Vital Source of Funding for Our Economy. Money market funds provide critical financing to every sector of the short-term credit market. Money market funds held an estimated 36% of the Treasury bills outstanding at the end of 2010,[4] and typically hold approximately 30% of repurchase agreements, 40% of commercial paper and 80% of short-term municipal securities. (1/7/2011 Comment Letter at 4.)

Money Market Funds Have Added $500 Billion to America's Checkbook. Money market funds provide an important alternative to bank accounts for cash investments, offering higher yields than deposit accounts under normal market conditions. Federated has estimated that these higher yields have added at least $500 billion to investor returns over the past twenty-five years. (1/7/2011 Comment Letter at 3-4.) This is a conservative estimate, as it is unlikely that yields

[4] Based on information contained in the 2011 Investment Company Act Fact Book and the Treasury Department's Monthly Statement of the Public Debt for December 31, 2010.

on bank deposits would have been as high without competitive pressure from money market funds.

Eliminating Money Market Funds Would Make Systemically Significant Banks Even More Significant and Increase the Size of the Federal Safety Net. Investors leaving money market funds would look primarily for other stable value investments. This means that a substantial portion of the cash currently held in money market funds would flood into banks as deposits. In fact, six of the largest U.S. bank holding companies currently control some $800 billion in money market funds assets. If money market funds are eliminated, these banks are unlikely to redirect this cash into financial products they do not control. Elimination of money market funds will therefore increase the size of banks already found to pose systemic risks to the financial system. (1/7/2011 Comment Letter at 7.) These additional deposits would significantly increase the size of the deposit base of banks subject to an explicit federal guarantee. This increase in the size of the federal safety net is exactly what Title I of the Dodd-Frank Act was intended to prevent.

Eliminating Money Market Funds Would Create a Credit Crunch in the Short-Term Funding Markets. A wholesale shift of cash from money market funds to banks would require banks to raise tremendous amounts of capital at a time when banks are already short of capital. To attract this capital, banks would have to make more profitable investments than the short-term obligations typically held by money market funds. This means that borrowers will find it harder to obtain short-term financing from banks and short-term interest rates will rise. (3/15/2011 Comment Letter at 5.) In other words, eliminating money market funds would create a "credit crunch" for high quality short-term borrowers while increasing the propensity of systemically significant banks to make riskier investments. This is hardly the formula for an economic recovery or for financial stability.

Eliminating Money Market Funds Will Increase the Level of Risk in the Financial System. Cash that was not shifted to bank deposits after the elimination of money market funds would probably flow into offshore funds or to unregulated alternative stable value products. Institutions would lose the benefit of professional management and diversification of their cash investments, and would probably become more reliant on rating agencies for credit analysis. This would necessarily increase the overall risks taken by cash investors. (1/7/2011 Comment Letter at 8.)

Money Market Funds Have Proven to Be More Resilient than Other Major Financial Institutions. Money market funds weathered the financial crisis far better than banks, brokers, insurance companies or government sponsored enterprises. Only one money market fund "broke a dollar"(it paid out over 99 cents per dollar to investors) during the crisis, the other 806 money market funds in operation in 2008 did not break a buck and more than 95% of those funds did not receive any support from their sponsors. In the forty years that money market funds have been in operation only one other fund has broken the buck, and it paid out ninety-six cents on the dollar to investors. The government did not bail out these investors.

In contrast, during the crisis, more than 350 FDIC-insured banks failed. Over the past 40 years more than 2800 insured banks have failed, at a cost to the government of more than $188 billion. These losses in the banking industry are all the more startling when one considers that the federal banking agencies have a staff of 26,000 personnel overseeing banks. Money market funds did not hold any "toxic" assets requiring a government bailout and large scale redemptions from the prime funds (the consequence of a general flight from credit risk during the crisis) were stopped by a limited and temporary guarantee program. (2/24/2011 Comment Letter at 3-5.) The government turned a profit on this program and was not required to make any payouts to investors. If banks and brokers were as resilient as

money market funds, the financial crisis would have been resolved by the end of 2008 at no cost to taxpayers.

Money Market Funds Have No Interest in a "Taxpayer Bailout." Since the financial crisis, Federated and the industry have consistently sought market-based solutions to any residual concerns about money market funds, paid for by the funds' advisers and investors. There are currently no "moral hazards" involved in managing the funds and we have no desire to create any. Yet many regulators continue to refer to an "implicit government guarantee" for money market funds and propose to increase investors' expectations that someone else will bear any losses incurred by their fund. Such public statements are counterproductive to the reform efforts and run the risk of confusing investors. (5/19/2011 Comment Letter at 1-2.)

Simpler Is Better. In an era of constrained federal budgets and severe limits on the ability of the federal government to finance future bail-outs or pay for a massive federal regulatory oversight staff, the simple and very conservative model used by the SEC in regulating and supervising money market funds should serve as a model for the way to proceed. Money funds are able to maintain their stable net asset value of $1 per share not because of an accounting rule, but because they are allowed to invest only in very short term, very high quality debt securities. Money funds do not use leverage, and are instead financed 100% by shareholder equity. Fundamental changes to this program of regulation would increase risk, not reduce it. Applying the failed model of federal bank regulation to money market funds is simply the wrong way to go.

Response to Proposals to Create Capital Requirements for Money Market Funds

As detailed in the ICI Statement, the SEC has acted to improve the ability of money market funds to withstand systemic events or shocks by amending Rule 2a-7. These changes have imposed a tangible, measurable cost in terms of reduction in yield to investors. Money market funds and their investors bear this additional cost in order to achieve the benefit of reducing systemic risk.

Some proposals, such as those of the so-called Squam Lake Group (the "Squam Lake Proposal"), would require either the fund or its adviser to maintain capital to protect the shareholders from losses incurred on the portfolio. These proposals are likely to be so costly that they would have the effect of killing the funds. In other words, the cost of trying to eliminate the risk of a money market fund ever breaking a dollar would be the complete loss of the benefits of money market funds.

At bottom, the Squam Lake Proposal would change money market funds into banks, by creating a junior layer of capital (either the adviser's or a series of non-redeemable shares) to protect the shareholders from losses. Nothing in the history of financial regulation suggests that this structure will work in a major financial crisis. In fact, it is the same structure used by collateralized debt obligations and structured investment vehicles, both of which were among the first financial entities to collapse during the recent financial crisis. (2/24/2011 Comment Letter at 6-7.)

Another problem with the Squam Lake Proposal is that it would decrease the stability of the market by replacing default risk with funding risk. The proposal would require funds that cannot meet the capital requirements to liquidate or convert to a floating NAV. A fund whose growth outstripped its capital raising abilities would have to shut down and liquidate its assets, even if there was nothing

wrong with its portfolio. This would create entirely arbitrary disruptions in the financial markets. (3/25/2011 Comment Letter at 8).

The ultimate problem with the Squam Lake Proposal and similar proposed capital requirements is that they would be too costly. Money market funds are highly efficient investments, with total operating expenses normally measured in tenths of a percent. Moreover, the difference between yields on prime and government money market funds are small, often no more than 10 basis points. This leaves little room for prime funds to increase their expenses in order to pay for capital to protect shareholders.

Advocates for using capital (whether held in the fund or provided by the adviser) to prevent money market funds from breaking a dollar have ignored these economic constraints. Even a 2% capital requirement would represent over a dozen years of advisory fees for managing a money market fund, and the cost of such capital could nearly double a fund's expense ratio. (3/25/2011 Comment Letter at 8-9). Prime funds cannot afford to attract enough capital to absorb losses on defaulted securities or to compensate their advisers for taking on this risk and still offer a significant yield advantage over government funds. The economic reality is that money market funds can only afford to build capital slowly up to a relatively small amount.

This is why Federated believes efforts to use capital to prevent money market funds from ever breaking a dollar cannot succeed, and why we advocate focusing on ways to limit the impact of such events on the rest of the industry and the general market. The liquidity requirements added to Rule 2a-7 have already done much to limit the potential impact of a fund breaking a dollar. All funds can now redeem up to 30% of their shares without selling a single security. Even in severely distressed markets, money market fund holdings are so short-term and

high quality that they could sell a substantial portion of their other assets without adding significantly to the market disruption.

If more is needed to contain the impact of a fund breaking a dollar, Federated would recommend using the limited resources of prime funds to enhance their response to such an event. We note that the industry's proposed liquidity bank is consistent with this view, insofar as it would provide additional liquidity during a crisis that should calm fears investors may have about their fund's ability to meet redemptions. In other words, while opinions may differ on the best approach, we believe that the industry agrees that regulators would spend their time more profitably on reducing the potential impact of a fund breaking a dollar than on trying to make sure that it never happens.

Conclusion

In conclusion, there is no justification for gambling with such a critical element of the U.S. financial system. Proponents of eliminating money market funds essentially propose to remove the source of 30 to 40% of the short-term financing in this country and hope that the markets will somehow "sort it out." We would therefore appreciate the Subcommittee's support of money market funds by urging regulators to focus on more beneficial proposals for strengthening our credit markets than eliminating money market funds or changing them into banks.