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Dear Friends:

I am writing on behalf of our client Federated Investors, Inc. ("Federated"), a major issuer of money market mutual funds ("MMFs"), to urge that as the banking agencies move ahead with the drafting of a Notice of Proposed Rulemaking implementing the new Basel Capital Framework ("Basel II"), they give consideration to excluding shares of MMFs from the definition of, and treatment as, "equity exposures."

Shares of MMFs have none of the risk characteristics of equities -- indeed, MMFs cannot and do not include equities in their portfolios -- and are widely regarded as cash equivalents. Not only would it be anomalous to treat such instruments as comparable to true equity investments, but to do so for Basel II purposes would create a needless and undesirable disincentive for institutions covered by Basel II to use MMFs as a very useful cash management tool and a safe repository for temporary liquidity.

This disincentive would arise because publicly-traded equity exposures are assigned a risk weighting of 300% under Basel II. Basel II permits local supervisors to provide for a lower risk weighting for equities that do not in the aggregate exceed 10% of an institution's Tier 1 and Tier 2 capital, and the Advance Notice of Proposed Rulemaking published by the U.S. banking agencies on August 4, 2003, indicates that such a "materiality bucket" is likely to be included in the U.S. implementing rules. However, to the extent that an institution invests in MMF shares, it would be "using up" its leeway under the materiality bucket to invest in true equities subject to a 100% risk weighting, thus exposing the "spillover" to the 300% or 400% risk weighting for equities outside the bucket. Accordingly, an institution that wishes to take advantage of the materiality bucket for true equities would have a disincentive to use MMFs as a cash management tool.

I have set out below a specific and narrowly confined proposal for addressing this issue that essentially adopts as a standard for excluding MMF shares from equity treatment the Securities and Exchange Commission's rule setting conditions that must be observed by investment companies that are held out as money market mutual funds. By excluding from the Basel II definition of equity exposures shares of funds that satisfy the conditions that must be met by money market mutual funds under the SEC rule, the agencies would avoid the anomaly of treating such shares as the equivalent of true equities, and would eliminate the disincentive for banking institutions to use MMFs as a means for prudently diversifying their liquidity investments with little or no risk.

<u>The Background of MMFs</u>

MMFs are open-end management investment companies registered under the Investment Company Act of 1940 (the "1940 Act") that have as their investment objective the generation of income and preservation of capital and liquidity through investment in short-term, high quality securities. First introduced in 1972, MMFs today hold total assets of more than $2 trillion. MMFs offered by Federated hold total assets in excess of $160 billion.

MMFs generally seek to maintain a stable share price, typically $1.00 per share, and this stable share price has encouraged investors to view investments in MMFs as an alternative to bank deposits or checking accounts, even though MMFs do not have federal deposit insurance. The SEC has observed that "investors generally treat money market funds as cash investments."[1]

MMFs have been widely accepted by both retail and institutional investors. Institutional investors have been attracted to MMFs for various reasons. As the Investment Company Institute has noted "the growth in business holdings of money funds is partly due to corporations' preference to outsource cash management to mutual funds rather than holding liquid securities directly."[2] Companies that purchase MMF shares are able to obtain daily liquidity at par, together with true daily choice, flexibility and economies of scale that are unavailable through internal management of their liquid assets.[3]

SEC Regulations Governing MMFs

Under the 1940 Act and its implementing rules, mutual funds generally are required to calculate current net asset value per share by valuing portfolio investments at market value, or if market values are not readily available, at fair value. However, the SEC has exempted MMFs from this requirement in order to enable MMFs to maintain a stable share price by using the amortized cost method of valuation or the penny-rounding method of pricing. The SEC's Rule 2a-7 under the 1940 Act effectively prohibits a registered investment company from holding itself out to investors "as a money market fund or the equivalent of a money market fund" (and thus from taking advantage of the exception that allows MMFs to maintain a stable net asset value per share) unless it meets specified conditions relating to portfolio maturity, portfolio quality, portfolio diversification, and portfolio liquidity. These conditions may be summarized as follows (a complete copy of Rule 2a-7 is enclosed):

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[1] *Revisions to Rules Regulating Money Market Funds*, Investment Company Act Rel. No. 21837 (Mar. 21, 1996, 61 Fed. Reg. 13955, 13957 (Mar. 28, 1996) ("*Money Market Rule Revisions*").

[2] Investment Company Institute Mutual Fund Fact Book at 30 (42d ed. 2002).

[3] *See id.*

Portfolio Maturity. The fund must maintain a dollar-weighted average portfolio maturity appropriate to the objective of maintaining a stable net asset value per share. It may not acquire any instrument having a remaining maturity of greater than 397 calendar days, and may not maintain a dollar-weighted average portfolio maturity of more than 90 days.

Portfolio Quality. The fund may purchase only securities that are denominated in United States dollars, pose minimal risk to the fund, and qualify as "Eligible Securities" under the rule. "Eligible Securities" are defined generally as (1) securities that are rated in one of the highest two short-term rating categories by a nationally recognized statistical rating organization, or (2) comparable unrated securities. Such securities must be determined by the fund's board of directors to present minimal credit risks.

Portfolio Diversification. Rule 2a-7 subjects MMFs to a variety of requirements designed to limit the fund's exposure to the credit risk of any single issuer.

Portfolio Liquidity. SEC rules also subject MMFs to stringent portfolio liquidity standards. An MMF is limited to investing no more than 10% of its assets in illiquid securities. The SEC considers a security to be illiquid if it cannot be disposed of within seven days in the ordinary course of business at approximately the price at which the fund has valued it.[4]

As a result of these SEC rules, an MMF is effectively precluded from investing in securities having an equity risk, and as a consequence MMFs do not invest in equities.

The Safety Record of MMFs

MMFs that may invest in the full range of securities permitted by Rule 2a-7 have had an impressive record of safety for over 33 years. The vast majority of such funds have never invested in any money market instrument that did not pay off at maturity. While there have been relatively isolated circumstances in which an MMF has experienced the potential for deviations between its stabilized share price and its market

[4] *Money Market Rule Revisions*, *supra* note 1, 61 Fed. Reg. at 13966.

based per share net asset value by virtue of its investments, in all but one of such instances the funds' investment advisers have purchased the distressed or defaulted securities from their funds at their amortized cost value, plus accrued interest, or have contributed capital to the fund to maintain the constant share price.[5]

A Proposed Approach for the Basel II NPR

Because the SEC's Rule 2a-7 in effect provides a definition for MMFs that imposes significant limiting conditions that are wholly consistent with the prudential concerns of bank supervisors, that rule offers a useful standard for the Basel II NPR to employ in this context. Federated proposes that the NPR exclude from the definition of equity exposures, and thus from a charge against the materiality bucket:

> shares in an investment company that is registered under the Investment Company Act of 1940 and that qualifies as a money market fund under Rule 2a-7 of the rules of the Securities and Exchange Commission under that Act.

Such a narrowly defined exclusion would be limited in its applicability to MMFs that have no equity-like exposure. The conditions that an MMF must satisfy to meet the requirements of Rule 2a-7 should provide assurance that an investment in the shares of an MMF does not present any market, credit, liquidity, or operational risk greater than a direct investment in the types of securities that MMFs are permitted to hold -- none of which would be treated as equity exposures under Basel II. Moreover, the adoption of such an exclusion would avoid the creation of any disincentive for institutions to invest in MMFs and would preserve the availability of this safe, proven and extremely useful cash management tool.

Such an approach would also be consistent with the underlying rationale of a host of decisions and rulings over many years, by various regulatory, legislative and judicial bodies, pursuant to which shares of MMFs are treated as the functional equivalent of their

[5] *Money Market Rule Revisions*, *supra*, 61 Fed Reg. at 13972 n.162.

underlying portfolio investments or recognized to be cash equivalents. I am enclosing a compendium of such decisions and rulings.

I have not addressed the separate issue of the risk weighting to be assigned to MMFs, and there are several approaches that might be taken to this question. I am inclined to believe that the most appropriate treatment would be to employ a "look through" approach that would allow the investing institution to calculate a weighted average risk weight based on the individual risk weights applicable to the different types of securities held by the MMF. I would be pleased to discuss that issue further with you.

Sincerely,

John D. Hawke

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Enclosures

Commenter submitted attachments that maybe retrieved from the Freedom of Information Office.