Letter of Comment No. 19
File Reference No. 3-29E
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Federated
World-Class Investment Manager®

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Director of Research and Technical Activities
Governmental Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Re: External Investment Pools/Project No. 3-29E

Dear Sir or Madam:

Please accept this letter on behalf of Federated Investors, Inc. ("Federated"),[1] to provide supplemental comments to the Governmental Accounting Standards Board ("GASB") relative to the use of amortized cost in financial statements for external investment pools (often referred to as local government investment pools or LGIPs). Our submission is a continuation of previous letters to you from Federated, composed in collaboration with David Freeman, Partner at Arnold & Porter, our external counsel in this matter. We strongly support the proposal of GASB to de-link GASB standards from the Securities and Exchange Commission's ("SEC's") Rule 2a-7, which was recently amended to restrict the use of amortized cost accounting for certain money market mutual funds.[2] Although we suggest improvements to the proposal, we do not intend these

[1] Federated has participated actively in the money market as it has developed over the years. Federated's first funds pre-date Rule 2a-7 by nearly a decade. 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 market fund to use the amortized cost method of accounting. Federated also received one of the initial exemptive orders permitting use of the amortized cost method of accounting in 1979. Federated also serves as investment adviser to some of the nation's largest external investment pools that are operated by state governments for investment of cash assets. Federated has substantial knowledge on the portfolio management and operational issues associated with use of amortized cost by external investment pools, as well as the needs and objectives of state and local governments related to their use of external investment pools.

[2] Adopting Release, *Money Market Fund Reform; Amendments to Form PF*, 79 Fed. Reg. 47736 (Aug. 14, 2014) (amending 17 C.F.R. § 270.2a-7) ("SEC Final 2a-7 Rule Release"). Among other changes, the SEC amendments will require, as of October 14, 2016, institutional prime money market funds and institutional municipal money market funds to price shares to the nearest 1/100th of a penny, abandon a stable net asset value of $1.00 per share and adopt a variable net asset value ("NAV") for pricing shares, and cease using amortized cost accounting to value portfolio assets with a remaining maturity in excess of 60 days. Retail money market funds and U.S. government securities money market funds will still be allowed to maintain a

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suggestions to detract from our overall support of the proposal, and urge GASB to adopt the proposal with minor modifications.

Flexibility on Numerical Values For Criteria

The central element of the proposal is to modify the prior GASB guidelines pertaining to the use of amortized cost accounting in financial statements of LGIPs; the prior guidance incorporated by reference SEC Rule 2a-7. The current proposal would instead set forth specific criteria for use of amortized cost by LGIPs. Federated strongly supports this decision by GASB to de-link external pool accounting from Rule 2a-7. Federated also strongly supports statements by GASB recognizing that, 1) its role is setting accounting standards for financial reporting, not regulating the operations of LGIPs, and, 2) that pricing shares at issuance and redemption rounded to the nearest penny is an operating decision for each state to make rather than a financial reporting issue.

Federated also supports GASB's decision to select prerequisite criteria for the use of amortized cost to increase the probability that the amortized cost value of shares will closely track their "fair value."[3] However, we suggest that the basic premise for the use of amortized cost for debt instruments -- that the owner intends to hold them to maturity and has the capability to do so -- not be forgotten. If they are not sold and do not default, any deviation between book value and market value is never realized. At maturity, book value equals the cash received from the issuer; therefore, the portfolio criteria should underpin this basic standard.

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stable NAV of $1.00 per share by rounding share prices to the nearest penny, and use amortized cost accounting for all portfolio assets.

[3] All external investment pools will continue to be permitted to use amortized cost to value portfolio assets with remaining maturities of 90 or fewer days. Given the very short duration of the portfolios, most portfolio assets of external investment pools that operate as stable value "dollar pools" have remaining maturities under 90 days. "Fair values" used for short-term high quality debt instruments are generated by mathematical "matrix pricing" models, not current market prices, and these models include variations of amortized cost valuations into their formulae. These model values are "level 2" valuations, as are amortized cost values. Amortized cost valuations of well-managed external investment pools will closely track their fair values within a few hundredths of a cent per unit even in stressed economic conditions, and are not a less accurate valuation than model "fair values."

The categories of portfolio criteria included in paragraph 4 of the proposal -- portfolio diversification, liquidity, weighted average maturity (WAM), weighted average life (WAL), maximum maturity of individual instruments, dollar denomination and credit quality of instruments, and reporting of a "shadow price" -- broadly speaking, are consistent with that approach. Inclusion of the objective that the LGIP seeks to maintain a stable net asset value ("NAV") per unit is also appropriate as a criterion.

Rule 2a-7 was written specifically for SEC-registered money market mutual funds to establish uniform national requirements for these portfolios. In contrast, GASB is considering a financial accounting standard for government-sponsored external investment pools. Recognizing that not all of the 14 risk-mitigating criteria identified in Rule 2a-7 are meaningful for use by external investment pools, and some of those criteria require modification to be relevant, we support GASB's desire to tailor the criteria accordingly. As noted in our prior letters, in our view GASB should also tailor the specific numerical values associated with these criteria in paragraphs 12 (60 days WAM), 13 (120 days WAL), 35 (10% daily liquid assets) and 37 (30% weekly liquid assets), rather than lift them from Rule 2a-7. The context of the proposal is different from the Rule 2a-7 scenario, and the values for these criteria and how they are used should reflect that basic fact.

Federated suggests that GASB allow somewhat more flexibility in the numerical values associated with each of the portfolio criteria required for the use of amortized cost accounting by external pools in paragraphs 12, 13, 35 and 37. Looking at the potential for price movements of the overall portfolio as opposed to setting hard, separate limits on each aspect of portfolio duration and liquidity, can increase the probability that amortized cost values of units will closely track fair value. Holistic consideration of the interaction of the portfolio duration and liquidity criteria can be achieved when shadow pricing and stress testing are used as part of pool management's approach to dynamically track and control the potential movement of the fair value of the units. Doing so also facilitates an LGIP's ability to achieve a higher level of portfolio return at the same level of risk or a lower level of risk at the same portfolio return. The convergence of shadow pricing and stress testing is a powerful combination of tools that also allows a portfolio to conform to the differences of each state's investment laws while maintaining a stable value per unit.

Under Federated's suggested approach to the criteria, a maturity standard would require a pool's portfolio to adhere to prudent (and short) limits on the duration of its portfolio. Rather than setting a specific weighted average portfolio maturity, weighted average portfolio life and daily and weekly liquidity levels, the standard would require that such limits be set by individual pools or state law and disclosed to participants with sufficient specificity to allow for auditing.[4] Forty-five states offer external investment pools for state and local government entities. The legal requirements for the pools that emanate from statutory provisions are different from state to state. So too the pools can and do differ in their purpose, i.e., bond proceeds, operating cash, etc., and in the user profiles of their participants. Setting one-size-fits-all national standards for all external investment pools would limit the ability of managers to manage to each external investment pool's unique needs within a best practices standard for the construct applicable in any given state.

The factors in the portfolio duration and liquidity criteria specified in paragraphs 12, 13, 35 and 37 work in combination. The mix of numerical limits is best adjusted to fit the context of the particular pool. Higher liquidity levels may offset slightly longer average maturities, or higher credit quality and shorter average portfolio maturity may offset slightly lower weekly liquidity levels, depending on the needs of the governmental investors in the pool and the context involved. The degree to which the amortized cost value tracks fair value is a function of all of these portfolio characteristics working in combination, not a function of any one of the criteria in isolation. Use of stress testing and shadow pricing predicts and documents how these factors work together to assure that amortized cost value closely tracks the mark-to-model value of the portfolio much better than pre-set numbers separately established for each criterion. Further, the state is able to appropriately tailor the specific numerical requirements for these criteria to best fit its external pool and investors.

Investors in external investment pools have predictable investment cycles, allowing the pool manager to manage the portfolio to accommodate those needs. Cash flows into and out of external investment pools tend to be predictable and seasonal for a given entity type. School districts have different investing seasonality from cities; cities differ from counties, and so forth. Cash flows correlate with such factors as tax receipt season and expense payment periods for each entity. There is also considerably greater transparency of these flows and of the individual entities' investing patterns to the investment manager than is the case with money market funds. It is possible and practical to know the underlying local government customer and to ascertain, often in advance, any special cash needs. This sort of relationship is less common with money

[4] Our December 2, 2014 letter provides additional detail regarding Federated's proposed principles-based approach.

market funds where assets are diverse across many kinds of different investors and are often placed through financial intermediaries.

Investors in external investment pools are far less likely than their money market fund counterparts to exhibit run behavior because, to put it simply, they have fewer places to run *to*. Public entities are not "retail" investors that are eligible to invest in stable NAV prime money market funds after the full implementation of the SEC's amended Rule 2a-7 in 2016. Bank deposits, a key alternative investment for many money market fund investors during crisis periods, are an undesirable option for public entities because amounts in excess of FDIC insurance limits generally are required to be fully collateralized,[5] which decreases the profitability to banks of the deposits and reduces banks' willingness to accept large deposits from state and local governments.

External investment pools are essentially a state government tool for coordinating and providing a professional, inexpensive method for the management of the assets of the various agencies and local entities within the state. External investment pools are made available at an attractive price and function like a member cooperative. They are, in essence, the preferred provider of cash management functions to governmental units within the state. Public entities are subject to strict statutory and regulatory restrictions when investing government funds. Indeed, some entities may be *required* to place cash balances in the state's external investment pool.

Allowing for local tailoring of the numerical components would not result in a less auditable set of requirements. Specific numerical requirements established for each pool based on local needs and state laws, and disclosed to investors, are clearly measurable and auditable. They do not give portfolio managers unlimited or unwarranted flexibility. Allowing each state to follow a more tailored approach to the cash flows of its pool(s) and the requirements of its state investment laws is consistent with principles

[5] *See, e.g.*, Letter from Steven N. McCoy, Georgia State Treasurer, to SEC (Sept. 16, 2013) (available at http://www.sec.gov/comments/s7-03-13/s70313-145.pdf) (describing requirement for collateralization of public deposits at banks); Department of State Treasurer, State of North Carolina, Collateralization of Public Deposits (rev. April 2013) (available at https://www.nctreasurer.com/fod/Resources/Collateralization.pdf) (describing North Carolina requirements for collateralization of public deposits at banks); State of Minnesota Office of the State Auditor, Statement of Position, Deposits of Public Funds (Depositories and Collateral) (rev. Sept. 2012) (available at http://www.osa.state.mn.us/other/Statements/DepositsPublicFunds1102Statement.pdf).

of Federalism and with the concept that GASB exists to set accounting standards, not to regulate state investment management practices. Allowing state variations, rather than imposing a single national standard for operation of external investment pools, was precisely why Congress chose to exclude external investment pools from regulation by the SEC under Section 2(b) of the Investment Company Act.

Federated therefore recommends that the proposal be modified to allow pools that engage in robust stress-testing of portfolio values (something not otherwise required by the proposal) to determine that unit values at amortized cost will closely track fair values; establish daily and weekly liquidity levels consistent with the known, documented cash flows of investors and limits on portfolio redemptions; and, be allowed to deviate from the specific numerical values for the criteria in paragraphs 12, 13, 35 and 37.

We recommend that the following language be incorporated into your proposal:

"Notwithstanding paragraphs 12 and 13 , a qualifying external investment pool shall be permitted to operate with longer weighted average maturity (of up to 90 days) and weighted average life (of up to 180 days) authorized by state law or formal investment policies that are adopted by the state, if (i) the external investment pool engages in monthly stress testing and shadow pricing of its portfolio to determine that the amortized cost value of its units will closely track their fair value across a range of market conditions, and (ii) adheres to prudent, short portfolio duration requirements established by state law or formal investment policies adopted by the state."

"Notwithstanding paragraphs 35 and 37, a qualifying external investment pool shall be permitted to operate with lower percentages of daily and weekly liquid assets that are established by state law or formal investment policies that are adopted by the state based upon the documented operational characteristics of the external investment pool and its investor governmental entities."

Liquid and Illiquid Investments

Although Federated agrees with the approach of requiring an external investment pool to have appropriate amounts of liquid investments, we suggest some small changes. In paragraph 34, a nonnegotiable bank certificate of deposit is described as an illiquid investment. We suggest that the proposal be clarified to treat a certificate of deposit as a liquid asset if it has a scheduled maturity within seven calendar days, even if nonnegotiable.

Consistent with our comments above, we also suggest that a state be allowed to establish lower minimums for daily liquid assets and weekly liquid assets if consistent with the documented operational characteristics of its external investment pool and its investing governmental entities. Examples include external investment pools for which more than one day's advance notice of a redemption is required (and daily liquid assets are established for the pending redemptions) or for which other redemption limits are disclosed consistent with paragraph 42(b) of the proposal, as well as external investment pools that have a strong, documented, predictable seasonality or other periodic net cash flow based upon the budget cycles or intermittent cash flows of the investing governmental entities. Liquid asset levels are better set when established in a manner consistent with these documented cash flow patterns. Additionally, transparency between the sponsoring states and their investors ensure that a full vantage point on cash patterns can in fact be obtained, regularly documented, and anticipated. States that offer pools are able to reach out at any time to their investors to ascertain upcoming cash flow needs. These relationships, fostered over time, have served pools well and have provided a "know your customer" advantage that supersedes the transparency of most money market funds.

Non-Traditional Repo

Subparagraph 27(c) of the proposed guidance restricts repurchase agreements ("repos") only to those with collateral of U.S. Government and agency securities. Repos are, in substance though not in form, a type of collateralized lending. Although in form the transaction involves a purchase and resale or sale and repurchase of the designated asset with the repo counterparty, because the counterparty is contractually committed to repurchase (or sell back) the instrument at a pre-set price, it is the creditworthiness of the counterparty that is relied on for completion of the transaction, not simply upon the quality of the collateral that is the subject of the repo. The repo collateral provides an extra assurance of repayment by a creditworthy counterparty.

This is particularly the case with repo in respect of anything other than U.S. government and agency securities (often referred to as "non-traditional repo"). Non-traditional repo is important to dollar pool LGIPs as well as MMFs to allow the funds to invest cash balances overnight with highly credit-worthy bank and securities firm counterparties. There is often a shortage of appropriate liquid investments to fill the daily and weekly liquid asset requirements for these funds. If only repos on U.S. government and agency securities are permitted, in many market conditions, funds may be hard-pressed to find appropriate investments to meet daily and weekly liquidity requirements.

We appreciate the need to assure the high credit quality of the fund's portfolio. In Federated's view, if very strict credit quality standards are applied to the counterparty on nontraditional repo, that goal is met. The body of paragraph 27, together with subparagraphs (a) and (b), assure the credit quality and prudence of the repo. Subparagraph (c) could better serve the overall objectives of the guidance by requiring that the securities collateralizing the repo must -- other than maturity -- be permissible investments for the fund. Our suggested modified Subparagraph (c) would require application of portfolio diversification requirements to the collateral as a portfolio asset. Our suggested revision would further require that, if the collateral is any instrument other than U.S. government or agency securities, the current value of the collateral must be not less than 102% of the principal balance of the repo. The counterparties specified in Paragraph 27 are effectively limited to those whose unsecured short-term debt would be permitted under the proposed criteria. The addition of collateral and conducing the transaction in the form of repo rather than as unsecured debt, only enhances the probability that the credit will be repaid fully. This helps assure that unit values determined using amortized cost will closely track unit values determined using fair value.

Our suggested revised subparagraph 27(c) would read as follows (underscoring indicates the added text):

> (c) The securities collateralized the repurchase agreement are either (i) securities of the U.S. government, including its agencies and instrumentalities, or, (ii) securities that are permissible investments under these criteria in all respects other than maturity and have a value of not less than 102% of the resale price provided in the repurchase agreement during its entire term.

We note that the SEC's amended Rule 2a-7 permits MMFs (other than U.S. government securities MMFs) to engage in non-traditional repo transactions. Accordingly, we respectfully suggest that the final guidance allow LGIPs to engage in non-traditional repo transactions with counterparties that meet the above-referenced credit quality standards.

Limitation to Highest Rated Securities

The proposal prohibits acquisition of portfolio investments in securities that are rated below the highest rating category, sets a hard cap of 3% as of a reporting date on continued holdings of portfolio securities that are rated in the second category of ratings ("second-tier securities"), applies stricter diversification limits on second-tier securities,[6] and prohibits continued holding of any securities rated below the second-highest level. The proposal does permit acquisition and ownership of portfolio securities that are not rated if the pool determines that it presents minimal credit risk and is equivalent in quality to securities rated in the highest category.

Congress in Section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 required federal regulators to remove references to credit ratings from federal regulatory requirements, and in response the SEC has proposed to remove them from Rule 2a-7[7] and the Office of the Comptroller of the Currency removed them from its rules on national bank investments and investments of bank-sponsored short-term investment funds.[8] This was done in part to address the overreliance by portfolio managers of regulated entities on credit rating agencies, as well as perceived institutional and market failings associated with the process by which credit ratings were issued and revised. Like many other managers, Federated continues to believe that ratings are an important information input in portfolio management. As with Congress, the OCC and the SEC, however, Federated believes that the investment manager of a portfolio should be responsible for conducting its own review of the creditworthiness of issuers of portfolio assets. In light of these legislative and regulatory actions and the events that led to them, Federated believes that, notwithstanding the points on ratings in B12 of the proposal, tying LGIP decisions to invest to -- and more significantly imposing a hard and

[6] Second-tier securities have a tighter percentage diversification requirement at the time of acquisition in Rule 2a-7 because they are permitted to be acquired as second-tier securities. The percentage cap does not operate to force MMFs to divest them at a later date based upon changes in circumstances. In any event, the SEC is in the process of removing ratings from the criteria in Rule 2a-7.

[7] SEC, *Removal of Certain References to Credit Ratings and Amendment to the Issuer Diversification Requirement in the Money Market Fund Rule*, 79 Fed. Reg. 47986 (Aug. 14, 2014).

[8] 12 C.F.R. 1.2(d) ("Investment grade" means the issuer of a security has an adequate capacity to meet financial commitments under the security for the projected life of the asset or exposure. An issuer has an adequate capacity to meet financial commitments if the risk of default by the obligor is low and the full and timely repayment of principal and interest is expected."); 12 C.F.R. 9.18(b)(iii)(E).

fast requirement to dispose of downgraded portfolio investments before a reporting date based solely on -- a credit rating, is not appropriate.

We suggest, in addition, that securities of the U.S. government and its agencies and instrumentalities (and any securities fully guaranteed as to principal and interest by the U.S. government) be exempted from the ratings requirements, much as they are from the diversification requirements by paragraph 31 of the proposal.

Resolving Deviations from Criteria

From time to time, typically as a result of events beyond the control of an external pool and its manager that occur after a portfolio security is acquired, some investments in a portfolio may deviate from the numerical criteria established in the proposal. Examples include a downgrade in the credit rating of an issuer, a merger of issuers, or net redemptions in a pool that cause its overall size to shrink—these are the events that typically decrease the denominator for measures of portfolio diversification and limits on holdings of second-tier securities. Given the very short maturities of portfolio assets and their very high credit quality, the situation normally resolves itself very quickly as portfolio assets mature and are replaced with new investments. In these situations, more often than not the best approach is simply to hold the non-conforming position to its near-term maturity at par value rather than to sell it.

The discussions at the GASB open board meetings indicated flexibility in the way in which an external pool conforms deviations from the portfolio criteria and recognized holding to maturity as a legitimate means to correct deviations by post-purchase events, and paragraph B-21 reflects this approach. Paragraph 21 indicates that pools can use this approach for the periods between reporting dates. With respect to portfolio holdings as of a reporting date, however, paragraph 21 sets a hard cap of three percent on the percentage of second-tier securities that can be included in the portfolio, and forbids holding any instruments rated below the second-highest level. Paragraph 30 imposes a further limit on percentage holdings of any one issuer that is rated below the highest category as a result of events occurring after their acquisition, apparently without regard to whether the time in question is at a reporting date. The impact of these requirements would be to force a sale of portfolio assets that were eligible investments at the time of acquisition, based upon a subsequent ratings downgrade.

We strongly urge that any hard caps on second-tier securities and prohibitions on holding securities rated below the second-highest category as well as diversification requirements apply only as of the date on which the security is acquired by the external investment pool, and that a pool not be required to sell portfolio assets that were within the criteria at the time of acquisition due to subsequent events (such as mergers of issuers, net redemptions from the pool and ratings downgrades of issuers) that are beyond the control of the external investment pool and its manager, even as of a reporting date.

If the event occurs on or immediately prior to a reporting date it may not be possible to correct the deviation as of the reporting date. And when the most prudent approach is to continue to hold the portfolio asset, it would not be appropriate to require the external investment pool to sell it in order to continue to value portfolio assets at amortized cost. If a situation causes the fair value of a particular portfolio asset materially to deviate from its fair value as of a reporting date, that portfolio asset should be reported at fair value rather than amortized cost.

Ratings downgrades of the LGIP itself, and access to external financial assistance, are identified in paragraph 7 of the proposal as factors to consider in determining whether a pool that fell out of compliance with the criteria for use of amortized cost for a period is permitted to use amortized cost to value all of its portfolio assets in subsequent periods. Federated suggests that the examples in subparagraphs 7(b) and 7(c) be removed from the proposal in its final form. Ratings and access to external financial support are not appropriate criteria for the use of amortized cost to value the portfolio assets of an external investment pool.

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Conclusion

We at Federated strongly support the proposal (although we urge the recommendations within that are truly borne from our day to day experience in managing external investment pools.) We applaud GASB for its diligent work in studying the issue, from both a strategic and pragmatic perspective.

Sincerely,

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CC: David F. Freeman, Jr., Esq.
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